DAVIS POLK & WARDWELL

The Debate Over Federal Insurance Regulation

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In March 2008, the Paulson Treasury issued its *Blueprint for a Modernized Financial Regulatory Structure* (the "**Paulson Blueprint**"), in which Treasury recommended the establishment of a federal insurance regulatory structure to provide for the creation of an optional federal charter. The Financial Services Roundtable has endorsed the concept of a national insurance regulator, noting that "just as the state/federal banking system works well for the industry and the economy—so too can a similar insurance system." In recent Congressional testimony, Treasury Secretary Timothy Geithner has said that "there is a good case for introducing an optional federal charter for insurance companies."

On April 2, 2009, Representatives Ed Royce (R-CA) and Melissa Bean (D-IL) introduced the National Insurance Consumer Protection Act ("**NICPA**"), the third attempt in less than three years to create federal insurance regulation. Not everyone thinks federal insurance regulation is an idea whose time has come, however. The CEO of the National Association of Insurance Commissioners (the "**NAIC**"), Therese Vaughan, recently testified in Congress that "[t]he state-based insurance regulatory system is one of critical checks and balances, where the perils of a single point of failure and omnipotent decision making are eliminated." The Illinois Director of Insurance, Michael McRaith, in his Congressional testimony characterized the optional federal charter as "a solution in search of a problem."

This memorandum uses NICPA as a filter through which to examine the likely features of any federal insurance regulatory regime; the regulation of insurance holding companies under a federal system and how that compares to state insurance regulation, and to banking regulation, on which it is largely patterned; and how such a regime may fit into the current regulatory reform framework.

Davis Polk & Wardwell will continue to monitor developments and issue newsflashes and memoranda as appropriate as federal insurance regulation continues to unfold.

Blueprint for a Modernized Financial Regulatory Structure

» **The Paulson Blueprint set out the following principal recommendations regarding insurance regulation:**

- creation of a federal regulatory structure and optional federal charter for insurers;
- creation of an Office of National Insurance within Treasury to regulate federally-chartered insurance providers and producers; and
- creation of an Office of Insurance Oversight as an interim measure to represent the US on international issues relating to the insurance sector and to advise Treasury on domestic and international policy issues.

Key Features of Federal Insurance Regulation

Both the Paulson Blueprint and recent legislative proposals, like NICPA, recommend the establishment of a federal insurance regulatory structure that provides for the creation of an optional federal charter. The Paulson Blueprint points out that the lack of regulatory uniformity in insurance regulation can lead to inefficiencies and undue regulatory burden, and can limit competition across states and internationally.

Recent developments in the life insurance industry add another front in the battle over federal insurance regulation. According to recent reports, Treasury will extend bailout funds to struggling life insurance companies. To the extent that insurers must rely on a capital infusion from Treasury to stave off rating downgrades and possible insolvency, the case for a federal regulator of national insurers is strengthened. Treasury has been slow to aid life insurers because the federal government has had a limited ability to assess their financial condition and has had to rely on state regulators in this regard. While proponents of federal insurance regulation point to such regulatory blind spots as evidence of the need for federal regulation, opponents disagree, asserting that life insurers are currently solvent and are viable in the long run.

In this context, it is informative to review the likely features of any federal insurance regulatory regime. These include a dual chartering system; financial, market conduct and policy standards; examination, reporting, and enforcement authority vested in a Commissioner of Insurance; prompt corrective action authority; preemption of state regulation; international cooperation; and conservatorship and receivership authority, including the establishment of a national insurance guaranty fund. In addition to providing for optional federal chartering, certain key issues regarding federal regulation of insurance companies are highlighted by reviewing the changes in NICPA from the prior federal insurance regulation legislation introduced by Reps. Royce and Bean, the National Insurance Act of 2007 (the "**2007 NIA**").

Following the Paulson Blueprint, NICPA proposes to establish within Treasury an Office of National Insurance (the "**Office**"), which would be headed by a National Insurance Commissioner (the "**Commissioner**"). The Commissioner would be appointed by the President, with the advice and consent of the Senate, for a five-year term. Under NICPA, the Commissioner would have a broad mandate to issue charters and to oversee the organization, incorporation, operation, regulation and supervision of national insurers and national

Lines of Insurance

» **Property and casualty insurance under NICPA includes the following insurance:**

- Surety bonds,
- Private passenger or commercial automobile,
- Homeowners,
- Mortgage guaranty,
- Financial guaranty,
- Commercial multiperil,
- General liability,
- Professional liability,
- Workers' compensation,
- Fire and allied lines,
- Farm or ranch owners,
- Multiperil,
- Aircraft,
- Fidelity,
- Surety,
- Medical malpractice,
- Ocean marine,
- Inland marine, and
- Boiler and machinery.

» **Life insurance under NICPA includes:**

- Disability income insurance,
- Long-term care insurance, and
- Supplemental health insurance.

insurance agencies, and to license, regulate and supervise national insurance producers.

Dual Chartering System

NICPA provides for the issuance of charters for national insurers and national insurance agencies. Under such a charter, a national insurer may engage in the sale, solicitation, negotiation and underwriting of property and casualty insurance or life insurance or the reinsurance of property and casualty insurance or life insurance. A national insurer may only provide insurance for the lines of insurance for which such insurer has been issued a federal charter. A national insurer may also establish and maintain separate accounts and protected cells in connection with insurance securitizations, provide investment advice and investment management services, and hold and accumulate funds pursuant to funding agreements.

A national insurer may only provide insurance for the lines of insurance for which such insurer has been issued a federal charter.

Under the optional federal charter provisions in NICPA, a national insurance agency may engage in the sale, solicitation and negotiation of (1) insurance policies issued by any national insurer or state-chartered insurer, (2) surplus lines of insurance and (3) non-admitted insurance for a non-admitted insurer. In addition, to the extent permitted by applicable state laws, a national insurance agency may sell, solicit or negotiate lines of insurance other than those for which such national insurance agency has been issued a federal charter.

Conversions. NICPA allows for the conversion by a state insurer or insurance agency into a national insurer or insurance agency and the conversion by a national insurer or insurance agency into a state insurer or insurance agency. Under NICPA, a national insurer or insurance agency is required to obtain the prior approval of the Commissioner in order to convert to a state charter. Interestingly, no such prior approval was required under the 2007 NIA. This change may have been a response to concerns that the dual regulatory system could allow for regulatory arbitrage by insurers seeking to avoid onerous regulations or investigations.

Lines of Insurance. Under NICPA, charters may limit a national insurer to a specified line of insurance, and shall only be issued for property and casualty insurance, life insurance or the reinsurance of property and casualty insurance and life insurance. In this regard, NICPA differs significantly from the 2007 NIA, which provided for separate national life insurers and national property and casualty insurers. Under NICPA, it would be possible for a national insurer to sell, solicit, negotiate or underwrite both life insurance and property and casualty insurance. The definition of "life insurance" under NICPA has also been expanded from the 2007 NIA definition to include "supplemental health insurance."

Reinsurance. NICPA generally treats reinsurers similarly to primary insurance providers. However, reinsurance is covered by NICPA only to the extent that the underlying insurance is covered by NICPA. For those areas not covered by NICPA, an insurance provider or reinsurance provider will still be subject to any applicable state regulatory regimes and licensing requirements in the states where they operate. It should be noted, however, that NICPA provides the Commissioner with exclusive jurisdiction over reinsurance pooling agreements involving both national insurers and affiliated state insurers.

NICPA generally treats reinsurers similarly to primary insurance providers.

Corporate Actions. Unlike the 2007 NIA, NICPA requires that an insurer provide prior notice to the Commissioner to establish or acquire a subsidiary. The 2007 NIA allowed the establishment of one subsidiary without the prior approval of the Commissioner, subject to certain restrictions. Furthermore, NICPA requires prior approval by the Commissioner for a national insurer to engage in mutual-to-stock conversions, stock-to-mutual conversions, mergers, acquisitions, assets transfers and other similar transactions. The 2007 NIA also required prior approval for such transactions, but only insofar as such transactions would have involved the national insurer, and laid out more specific guidelines and rules for such approvals.

Federal Licensing of Insurance Producers. NICPA provides for federal licensing of national insurance producers. A national producer license may authorize a person to sell, solicit or negotiate (1) insurance for a national insurer or a state-chartered insurer, and (2) surplus lines of insurance and non-admitted insurance for a non-admitted insurer. However, a producer licensed by a state may sell, solicit or negotiate insurance for a national insurer even if such person does not have a national insurance producer license.

Self-Regulatory Organizations. Under NICPA, the Commissioner may provide for the registration of insurance self-regulatory organizations ("**SROs**")

Financial Standards

» **Under NICPA, the Commissioner is directed to establish, by regulation, standards for national insurers and national insurance agencies on:**

- accounting and disclosure;
- auditing;
- risk management;
- internal controls;
- investment;
- capital and liquidity;
- actuarial opinions;
- reinsurance; and
- such other matters as the Commissioner deems necessary to ensure financial stability and integrity of national insurers and national insurance agencies.

and supervise and regulate any such SRO. NICPA allows the Commissioner to delegate any of his or her powers to any insurance SRO, unless otherwise specified in NICPA. For example, NICPA specifically prohibits delegations of chartering and organizing authority, charter conversion authority, the regulation of certain bulk transfers and the regulation of national insurers that are also affiliates of an insurance holding company.

Financial, Policy and Market Conduct Standards

Financial, policy and market conduct standards for national insurers and insurance agencies is another likely feature of any federal insurance regulatory system.

Financial Standards. Under NICPA, the financial standards for national insurers and insurance agencies would include capital and liquidity standards. Relative to the 2007 NIA, NICPA grants the Commissioner more flexibility in terms of the type of financial regulation that the Commissioner may promulgate. NICPA does not require the Commissioner to conform such regulations to the Standards and Models of the NAIC, although the Commissioner must take the NAIC standards, models, practices and instructions into consideration.

> The Commissioner may not require a national insurer to use any particular rate, rating element or price.

Policy Standards. Any federal insurance regulation, like NICPA, will likely provide that a Commissioner must establish general policy requirements, as well as requirements for different categories of policies to be issued by national insurers. Under NICPA, for example, no national insurer may issue a policy until a policy form has been filed with the Commissioner. However, under NICPA, the Commissioner may not require a national insurer to use any particular rate, rating element or price. This approach echoes the Paulson Blueprint's call to promote competition by not subjecting insurers to rate regulation or price setting by the government. NICPA differs, in this regard, from the 2007 NIA, which did not prohibit regulation of rate, rating element or price for life insurance. Some view this change to prohibit rate setting for life insurance as potentially diluting consumer protections, as many states currently impose some form of rate regulation for insurance products.[1]

[1] *See generally* H. Scott, Optional Federal Chartering of Insurance: Design of a Regulatory Structure, 4th Annual Insurance Reform Summit, March 2007.

Market Conduct Standards. In addition to setting financial standards for national insurers and insurance agencies, federal insurance regulation, like NICPA, is likely to require market conduct standards for national insurers, national insurance agencies and national insurance producers. The President of the NAIC, Roger Sevigny, has criticized NICPA as a proposal which would dismantle current state-based consumer protections. Perhaps in anticipation of such criticisms that federal regulation would be less protective of consumers than state regulation, NICPA would require the Commissioner to implement the "Unfair Trade Practices Act" and the "Unfair Claims Settlement Practices Act" of the NAIC. These standards are more specific than what the 2007 NIA proposed, and it is an instance where the Commissioner is required to conform to NAIC standards, rather than having to merely take such standards into consideration.

Reporting, Examinations and Enforcement

In addition to chartering national insurers and national insurance agencies, any federal insurance regulation will provide for some mechanism to gather information, conduct examinations of regulated entities, and enforce its rules and regulations on regulated entities. NICPA provides for each of these functions to be carried out by the Commissioner, who also has some authority over insurance holding companies and affiliates of national insurers and insurance agencies. In this respect, NICPA draws upon certain aspects of federal banking law, as discussed below in "Regulation of Insurance Holding Companies."

Reporting and Examinations. Under NICPA, the Commissioner may require national insurers and national insurance agencies to submit reports containing information in such form as the Commissioner prescribes by regulation. Moreover, the Commissioner would have prompt and reasonable access to officers, employees, agents, books, records and documents of an insurer or agency, upon request.

The Commissioner would also be responsible for examining national insurers and national insurance agencies, and may conduct an examination of a national insurer or national insurance agency as he or she considers necessary. Each national insurer would be subject to an on-site examination by the Commissioner not less than once during any 24-month period. Any national insurance agency would be subject to examination by the Commissioner in response to a complaint or evidence that such agency has violated or is about to violate a law, rule, regulation, written condition or written agreement.

Enforcement Powers

» **The Commissioner may:**

- revoke or suspend the charter of a national insurer or national insurance agency, or
- revoke or suspend the license of a national insurance producer.

» **With respect to a national insurer, national insurance agency, national insurance producer or any insurer-affiliated party, the Commissioner may:**

- issue cease and desist, prohibition, suspension and removal orders, or
- impose civil money penalties.

National insurance producers would be also be subject to examination and reporting requirements. Moreover, the Commissioner would be required to develop and implement an electronic database consisting of information relating to national insurance producers and an electronic communication network that links the Commissioner with state insurance regulators and national insurers, national insurance agencies and state insurers for an electronic exchange of such information.

The Commissioner also has the power to examine certain affiliates of a national insurer. See the discussion under "Regulation of Insurance Holding Companies" below.

Enforcement. Under NICPA, the Commissioner may order the revocation or suspension of the charter of a national insurer or national insurance agency under certain conditions, such as a violation of law or regulation. The Commissioner may also revoke or suspend the license of a national insurance producer under certain conditions, such as a violation of law or regulation, or the financial irresponsibility of the insurance producer. This enforcement power is likely to be a feature of any federal insurance regulation.

The Commissioner may also issue cease and desist, prohibition, suspension and removal orders, and impose civil monetary penalties upon a national insurer, national insurance agency, national insurance producer and any insurer-affiliated party under certain circumstances. Here, NICPA references Section 8 of the Federal Deposit Insurance Act (the "**FDIA**"), providing for such orders "on the same grounds and the same terms and conditions applicable to the issuance of such orders by a Federal banking agency under section 8 of the [FDIA]" as if such parties were insured depository institutions.

Supervision of National Insurance Producers. Unless supervised by a national insurance agency, a national insurer must supervise a national insurance producer if the producer is an employee or agent of the insurer, and the principal activity of the producer is devoted to producing insurance business for the insurer. A national insurance agency must supervise a national insurance producer if the producer is an employee or agent of the agency and the sale, solicitation and negotiation of insurance is within the scope of employment or

> The Commissioner would be required to establish standards for supervision of national insurance producers that may not conflict with the rules of certain SROs.

is pursuant to an agreement between the producer and the agency. The Commissioner would oversee a national insurance producer that is not otherwise subject to supervision by a national insurer or national insurance agency. The Commissioner would be required to establish standards for supervision that may not conflict with the rules of certain SROs. Unlike the 2007 NIA, NICPA does not provide an exception from supervision for wholesale life insurance brokerage agencies.

Consumer Protection Principles

In line with an emphasis on consumer protection, NICPA provides for a Division of Consumer Affairs, a Division of Insurance Fraud, and an Office of the Ombudsman within the Office of National Insurance. One criticism by state regulators of the optional federal charter is that a federal system would weaken consumer protection features already in place by undermining consumer access to local regulatory officials.

Division of Consumer Affairs. The Division of Consumer Affairs would be headed by a Director, to be appointed by, and reporting to, the Commissioner. The Division of Consumer Affairs would have an office in each state and a centralized call center with a toll-free number. The Director is intended to act as a liaison between the Office and consumers of insurance, and to receive questions and complaints from consumers regarding the acts and practices of national insurers, national insurance producers and national insurance agencies. The President of the NAIC has called this concept "redundant" to state-based insurance regulation.

Moreover, each national insurer and national insurance agency would be required to appoint a liaison to serve consumers and address complaints or disputes, and would be required to establish policies and procedures designed to reasonably ensure fair handling of consumer complaints and disputes. These requirements are more specific than what was provided for in the 2007 NIA, and may represent a concerted effort to focus on consumer protection.

Division of Insurance Fraud. The Director of the Division of Insurance Fraud would be tasked with investigating suspected fraudulent insurance acts by national insurers, national insurance agencies and national producers, and other persons. Whereas the 2007 NIA would have authorized private rights of action by national insurers, national insurance agencies and national insurance producers, NICPA does not authorize such a civil action, but instead provides that any injured party can receive restitution from any person convicted under

NICPA, and that such restitution would be the sole remedy available to the victim.

Prompt Corrective Action Authority

The Paulson Blueprint called for a capital-based system of prompt corrective action similar to that used by the Federal Deposit Insurance Corporation with respect to depository institutions. Under NICPA, the Comptroller General of the US is tasked with conducting a study to identify the optimal prompt corrective action regime applicable to national insurers, and is required to look to the prompt corrective action regime in Section 38 of the FDIA with respect to insured depository institutions and to the NAIC model regulations, in particular. The Commissioner must then promulgate regulations applicable to national insurers that he or she determines to be appropriate and consistent with the recommendations in such report. Such rules and regulations must include capital measures and categories, capital standards, supervisory criteria, restrictions on permissible actions of such insurers, and conservatorship and receivership requirements, among others.

Funding

Under NICPA, the Office is to be funded through annual assessments on national insurers, national insurance agencies and national insurance producers, together with such other fees, including fees imposed on examinations, as the Commissioner determines to be appropriate. The possibility that large insurers may become part of the federal regulatory system, along with their related fees, potentially leaving smaller insurers with the states, may be part of state opposition to the optional federal charter.

Preemption of State Regulation

Any federal insurance regulation will necessarily preempt in some respects state insurance regulation. NICPA provides that state laws with respect to national insurers, national insurance agencies and national insurance producers would be preempted by federal laws and regulations, with certain exceptions. This feature is relatively unchanged from the 2007 NIA. However, certain other state laws would continue to apply to national insurers, national insurance agencies, and national insurance producers. Under NICPA, national insurance providers would still be subject to, among others, certain state tax laws, state laws prescribing compulsory coverage requirements for workers' compensation and motor vehicle insurance, and state laws relating to participation in an assigned risk plan, mandatory joint underwriting association, or any other mandatory residual market mechanism designed to make insurance available to

Relationship to State Law

» **With certain exceptions, the following state laws with respect to national insurers, national insurance agencies and national insurance producers, would be preempted by federal laws and regulations:**

- state licensing;
- state examination;
- state reporting;
- state regulation; and
- state supervision.

» **The following state laws would continue to apply to national insurers, insurance agencies and insurance producers:**

- certain state taxes;
- state unclaimed property and escheat laws;
- state law relating to participation in an assigned risk plan, mandatory joint underwriting association or any other mandatory residual market mechanism designed to make insurance available to those unable to obtain insurance, subject to certain conditions; and
- compulsory coverage requirements for workers' compensation and motor vehicle insurance.

those unable to obtain insurance in the voluntary market, subject to certain conditions. Despite these concessions to state concerns, state opposition to federal insurance regulation has largely not wavered.

International Cooperation

One of the benefits of federal insurance regulation is that it allows for coordination on international regulatory issues. The Paulson Blueprint identified the fact that no regulatory official at the federal level can speak for the interests of US regulators of insurers and reinsurers as one of the competitive reasons for federal insurance regulation. Under NICPA, the Commissioner is authorized to engage in international efforts to secure bilateral and multilateral agreements with foreign insurance regulators and regional and global regulatory organizations. Also under NICPA, to the extent a non-US insurer is eligible to conduct a cross-border business pursuant to such an international agreement, no state may prevent or restrict such non-US insurer from engaging in the activities authorized under such international agreement.

Conservatorships and Receiverships

Under NICPA, the Commissioner may appoint a person as a conservator or receiver for a national insurer if certain grounds exist. The grounds for establishing a receivership or conservatorship include the insolvency of the national insurer, substantial dissipation of assets or earnings due to a hazardous practice or a violation of federal or state law, the hazardous condition of the insurer, the willful violation of a cease and desist order, concealment of books, records or assets from the Commissioner, the inability to pay its obligations, certain violations of law, criminal money laundering, and consent of the insurer. The 2007 NIA provided for the appointment of a receiver on the same grounds.

If a national insurer is placed into receivership for the purpose of liquidation, claims on life insurance policies issued by such an insurer would be paid in accordance with the "Life and Health Insurance Guaranty Association Model Act" of the NAIC, and claims on property and casualty insurance policies would be paid in accordance with the "Post-Assessment Property and Liability Insurance Guaranty Association Model Act" of the NAIC.

Guaranty Funds

Currently, individual state guaranty funds provide whatever guaranties may be available to policyholders in the event of an insurer's insolvency or inability to pay claims. Under this state-based system, licensed insurers in a state automatically become members of that state's guaranty fund. NICPA would establish the National Insurance Guaranty Corporation (the "**Corporation**"), which is designed to act as the equivalent of state guaranty funds for national insurers. For the purposes of paying the claims of policyholders and other claims against a national insurer that is placed into receivership, the Director of the Corporation would impose assessments only on those national insurers providing the same type of insurance as the national insurer that is placed into receivership. The Director would be given the flexibility to consider subsets of property and casualty insurance or life insurance as different types of insurance. Under NICPA, any assessment upon a national insurer would not be imposed until such funds are needed. This post-event assessment practice is consistent with the current practice of all of the states except one.

In addition to participating in the Corporation, a national insurer would also be required by NICPA to participate in the state guaranty association for a line of insurance in each state in which such insurer is doing business in such line of insurance. NICPA prevents states from charging discriminatory assessment rates against national insurers. The provisions of NICPA are quite different in this regard than the provisions in the 2007 NIA. Under the 2007 NIA, a national insurer would have to participate in the Corporation only if the state guaranty association was not considered a "qualified association." A qualified association was defined as a state guaranty association that admits both state and national insurers, provides certain benefits to policyholders when an insurer is placed into receivership and is governed by a board of directors meeting certain representation characteristics.

A national insurer would be required to participate in the state guaranty association for a line of insurance in each state in which such insurer is doing business in such line of insurance.

In this respect, it is interesting to note that an insurer that obtains a federal charter could face Corporation assessments as well as state assessments. One issue that will continue to be debated and determined is the extent to which this and other features may deter participation in a federal system, or whether the benefits of a federal charter would outweigh such additional costs.

Regulation of Insurance Holding Companies

One of the key promises of a federal insurance regulatory system is to provide consolidated supervision over insurance holding companies. The lack of consolidated supervision over insurance holding companies has been a deficiency in the regulatory system most recently highlighted by the demise of AIG. In 2009, Rep. Bean promoted NICPA by citing "the meltdown of insurance giant AIG and the broad crisis in the nation's financial system as proof of the vital need for regulatory reform."

NICPA would regulate national insurance holding companies to an extent not seen in previous bills proposing an optional federal insurance charter. In this context, it is useful to examine how insurance holding companies might be regulated under federal insurance regulation and, specifically, how they would be regulated under NICPA. Certain key features of holding company regulation, including control determinations, affiliate transactions, examinations, reporting requirements, financial standards, and prompt corrective action, mirror bank holding company regulation, and can be compared to state regulation of insurance holding companies.

"Control" for National Insurance Holding Companies

» **Subject to certain exemptions, a person will be deemed to control a national insurer or national insurance agency if that person:**

- has a direct or indirect ownership interest and the power to direct the management or policies, or
- has the power to vote 25 percent or more of any class of voting securities.

» **The Commissioner may disapprove of an acquisition of control of a national insurer if:**

- it would jeopardize the financial stability of the national insurer or prejudice the interests of the customers of such insurer,
- the competence, experience or integrity of the acquiring person indicates that it would not be in the best interest of the customers of the national insurer, or
- the acquiring person fails to furnish the Commissioner with all required information.

Control Determinations

Under NICPA, a "national insurance holding company" is a company that controls a national insurer or national insurance agency. Subject to certain exceptions, a person who (1) has a direct or indirect ownership interest in a national insurer or national insurance agency and the power to direct the management or policies of such national insurer or national insurance agency, or (2) has the power to vote 25 percent or more of any class of voting securities of such national insurer or national insurance agency will be deemed to control such national insurer or national insurance agency. A holding company that controls a state-chartered insurer or insurance agency is not subject to regulation by the Commissioner.

Interestingly, with respect to the second prong of the control definition, the 25 percent threshold for voting securities is greater than the 10 percent threshold that typically signals control under state insurance laws. The higher threshold is more analogous to the definition of "control" in the Bank Holding Company Act. Nevertheless, if NICPA is enacted, any investor taking a stake in a national insurer or a national insurance agency, whether directly or indirectly, could be deemed to be an insurance holding company under the first prong of the control definition if the investor also becomes entitled to direct the management or policies of such national insurer or national insurance agency. This suggests that the issue of "control" determinations may be a key issue under NICPA or other legislation that may be enacted.

Change of Control Requirements

Any investment in a national insurer that results in an investor acquiring control of such national insurer would trigger the change of control provisions of NICPA. As such, the investor would have to provide the Commissioner with written notice of its intention to acquire control of a national insurer and could not consummate the transaction prior to the expiration of the Commissioner's disapproval period which is initially 60 days but may be extended twice, for no more than 45 days each time.

The 2007 NIA would have provided the Commissioner more bases for disapproving control acquisitions than NICPA provides. Under the 2007 NIA, for example, the Commissioner could disapprove a transaction if it was expected to harm the insurance-buying public. Under NICPA, the Commissioner may disapprove of the acquisition, if: (1) the financial condition of the acquirer or the future prospects of the institution might jeopardize the financial stability of the national insurer or prejudice the interests of the customers of such insurer, (2) the competence, experience or integrity of the acquiring person indicates that the acquisition would not be in the best interest of the customers of the national insurer or in the interest of the public, or (3) the acquiring person fails to furnish the Commissioner with all required information.

State Change of Control Provisions. While state regulators do not regulate insurance holding companies to the same extent that they regulate insurance subsidiaries operating in their jurisdiction, there are a number of provisions under state insurance laws that affect insurance holding companies. In particular, any change of control of a regulated insurance subsidiary must be approved by the relevant state regulator. As part of its review of a change of control transaction, a regulator will examine the management and directors of the acquiring company including management and directors at the parent holding company level. If the regulator is not satisfied that the management or directors are trustworthy, the regulator can order untrustworthy individuals to be replaced and can seize any insurance subsidiary operating in its jurisdiction if its orders are not respected.

Transactions with Affiliates

As in the 2007 NIA, NICPA would regulate a national insurer that is a member of an insurance holding company by: (1) imposing standards on transactions between such national insurer and its affiliates and (2) requiring approval, or in some cases non-disapproval, of certain affiliate transactions. For example, transactions between a national insurer and an affiliate must be on terms that are fair, reasonable, and at least as favorable to the national insurer as those that would be offered to, or would apply to, a non-affiliate.

Affiliate transactions must be on terms that are fair, reasonable, and at least as favorable as those that would apply to a non-affiliate.

This provision is analogous to the restrictions in Section 23B of the Federal Reserve Act on transactions between affiliates and also bears some resemblance to equivalent provisions that exist under state insurance laws. For example, in many states, the state insurance laws require that the terms of such a transaction be fair and equitable, that charges and fees be reasonable and that the books and records of each party to the transaction be maintained so as to clearly and accurately disclose the nature and details of the transaction.

In addition, under state insurance regulation, the regulator's prior approval is required for insurer transactions with affiliates that involve the sale, purchase, exchange or loan of more than a certain percentage of a regulated insurer's admitted assets. The threshold percentage that triggers the requirement for regulatory approval varies from state to state but is usually three to five percent. Some transactions within a holding company system, including reinsurance transactions or sales, purchases, exchanges or loans above a certain percentage of the insurer's admitted assets that is lower than the percentage that would trigger the approval requirement, require that the regulator be notified in advance.

Financial Standards

NICPA directs the Commissioner to establish, by rule or order, capital, liquidity, dividend, operational, and any other standards for a national insurance holding company that the Commissioner deems appropriate to ensure the solvency and sound operation of each national insurance holding company.

The Commissioner may establish any other standards for a national insurance holding company appropriate to ensure the solvency of each national insurance holding company.

NICPA states that it "shall not be construed to conflict with or supersede the provisions of any other Federal law or regulation governing the regulation of holding companies, including financial holding

Insurance Holding Company Regulation

» **National insurance holding companies would:**

- have to file reports with the Commissioner,
- be subject to examination by the Commissioner,
- be subject to corrective action by the Commissioner,
- be subject to standards to ensure the solvency of the holding company, and
- be subject to standards for affiliate transactions with a national insurer.

companies … and savings and loan holding companies." This would seem to imply that regulation of national insurance holding companies that are also bank or financial holding companies under the Bank Holding Company Act would continue to be conducted by the Federal Reserve.

In the fall of 2008, Treasury stated that insurers would only qualify for federal bailout funds if their holding companies were bank or savings-and-loan holding companies. As a result, a number of life insurers acquired savings and loan associations so they could qualify for bailout funds. This allowed for a level of federal oversight over the insurance holding companies that did not otherwise exist. Federal insurance regulation would both allow for federal oversight over insurance holding companies, and could provide a basis for the rescue of such companies if necessary in the future.

Reports and Examinations

Under NICPA, national insurance holding companies would be required to file reports with the Commissioner with information as specified by the Commissioner, and such holding companies would be subject to examinations by the Commissioner, although NICPA directs the Commissioner to use reports and examinations required by other federal agencies of such holding companies to the fullest extent deemed feasible.

Other Enforcement Powers

In addition to the provisions of NICPA described above that apply specifically to national insurance holding companies, certain other enforcement powers of the Commissioner that apply broadly to national insurers and national insurance agencies are also applicable to national insurance holding companies and to their affiliated parties. Specifically, NICPA empowers the Commissioner to issue cease and desist, prohibition, suspension and removal orders and to impose civil money penalties upon any national insurance holding company. The provisions of NICPA that deal with the Commissioner's enforcement powers indicate that orders issued by the Commissioner will be issued on the same grounds and the same terms and conditions applicable to the issuance of such orders by a federal banking agency under Section 8 of the FDIA, as if the insurer was an insured depository institution, the Commissioner was a federal banking agency, and a policyholder was a depositor. See the discussion above under "Reporting, Examinations and Enforcement."

Corrective Action

NICPA also authorizes the direct regulation of national insurance holding companies through corrective action by the Commissioner if the Commissioner has reasonable cause to believe that the holding company's activities pose "a significant risk to the solvency of the national insurer, jeopardizes the interests of the policyholders of such insurer, or is incompatible with the public interest." Any such corrective action taken by the Commissioner is subject to a hearing in a US district court within 10 days of notice being given by the Commissioner of such corrective action, under a "reasonableness" standard of review.

Conservatorships and Receiverships

The powers given to the Commissioner to regulate insurance holding companies are somewhat at odds with the conservatorship and receivership provisions in the proposed legislation. Although the Office would be charged with monitoring the solvency of a national insurance holding company, it would only have the authority to establish a conservatorship or receivership for the national insurer and not the holding company, the insolvency of which would be governed by the Bankruptcy Code. The rationale may be that the federal guaranty funds only provide for the insolvency of the insurer, and the Office would not have any expertise in the insolvency of non-insurance subsidiaries or holding companies.

The Office would only have the authority to establish a conservatorship or receivership for the national insurer and not the holding company.

Federal Insurance Regulation in a Regulatory Reform Framework

NICPA calls for the President to designate a systemic risk regulator for "covered institutions," *i.e.*, national insurers and insurance companies organized and supervised under state law. This represents an expansion from the 2007 NIA, which did not provide for such an agency. The systemic risk regulator would be distinct from the Office and would be a federal agency "that has experience in financial regulation and supervision as the systemic risk regulator for covered institutions." Notably, though the systemic risk regulator would be designated for insurers, it can request information from any insurer affiliate, can participate in the examination of any insurer affiliate, and can suggest corrective action with respect to any insurer affiliate.

The systemic risk regulator provisions are perhaps an attempt to tie NICPA to the recent discussions regarding systemic risk regulation and regulatory reform generally. The Paulson Blueprint did not discuss the concept of a systemic risk regulator for insurance, but recently Treasury Secretary Timothy Geithner outlined a proposal for a systemic regulator over systemically important firms, including insurance companies and hedge funds, whose failure could jeopardize the stability of the US financial markets. See Davis Polk & Wardwell's March 30, 2009 memorandum entitled Treasury's Rules of the Road for Regulatory Reform. Under Treasury's proposal, the systemic risk regulator would designate certain financial firms as "systemically important" based on certain criteria, including the firm's size, leverage, and potential impact on the US economy. Under Treasury's proposal, the systemic risk regulator may set capital requirements, risk management requirements, and otherwise become the consolidated supervisor of, such systemically important financial firms.

This raises a question about how a systemic risk regulator for insurance companies would coordinate with any other functional regulator and any separate systemic risk regulator that may exist for systemically important financial services firms.

As of the date of this memo, Treasury has not commented on NICPA. The CEO of the NAIC has noted that the nature of systemic risk differs for insurance companies—for example, they have less leverage, liabilities that are generally independent of economic cycles and longer investment horizons—and therefore any federal regulatory effort must take account of such differences. Additionally, the Illinois Director of Insurance stated in his Congressional testimony that "it is unlikely that any one insurer is 'too big to fail'" in part because state-based guaranty funds would protect existing policyholders and pay claims. Some draw distinctions between categories of insurers. For example, in a recent letter to House and Senate lawmakers, property and casualty insurers insisted that they did not pose systemic risk to the financial system, drawing a contrast to life insurers. To the extent that systemic risk in the insurance industry may not apply to a single insurer, but rather to categories of insurers, NICPA seems to acknowledge this issue, allowing for the systemic risk regulator to act with respect to "any category of covered institutions."

Coordinating Council for Financial Regulators

» **This Council, to be chaired by the Treasury Secretary, would consist of the heads of:**

- the Federal Reserve,
- the Securities and Exchange Commission,
- the Commodities Futures Trading Commission,
- the Office of the Comptroller of the Currency,
- the Office of Thrift Supervision,
- the Federal Deposit Insurance Corporation,
- the Office, and
- three individuals, appointed by the President with the advice and consent of the Senate, knowledgeable in state regulation of banking, insurance and securities.

» **The Council would not have any independent supervisory or regulatory authority.**

However, the recent announcement that Treasury may provide some bailout funds to life insurers may lend support to the need for a systemic risk regulator for insurers. Although policyholders are currently protected by state guaranty funds, certain insurers, in the same manner as AIG, could present a systemic risk because of their large presence in the bond market, potential liquidity problems, and their use of derivatives such as credit-default swaps. Whereas property and casualty insurers are generally less leveraged and are considered less vulnerable to financial shocks, some argue they can be vulnerable to rating downgrades and may also pose some systemic risk.

Under NICPA, the systemic risk regulator would have the power to:

» request information on the activities and operations of covered institutions and their affiliates from the institution or the affiliate and from the Office or a state insurance authority responsible for supervising the covered institution;

» participate in examinations of insurers or an affiliate with the Office or the state insurance authority;

» recommend corrective action to the Commissioner or a state insurance authority if it determines that a covered institution, an affiliate, a category of institution or any product or service offered by a covered institution is having or would have serious adverse effects on US economic conditions or financial stability;

» issue a rule or order to address the activities, under certain circumstances, if its recommendations are not addressed by the Commissioner or a state insurance authority; and

» in consultation with the Commissioner, determine if a state insurance provider is systemically important and should be required to have a federal charter.

Substantively, the systemic risk regulator appears to operate as a third-party watchdog, with the authority to intervene in cases where it sees potential risks that needed to be addressed. However, NICPA sets up a checks-and-balances system that generally prevents the systemic risk regulator from acting on its own. If the systemic risk regulator wanted to issue a rule or order to address a recommendation not addressed by the Commissioner or a state insurance authority, it would have to obtain a two-thirds vote of the Coordinating Council for Financial Regulators (the "**Council**") that such corrective action is

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necessary "to mitigate or avoid an impending serious adverse effect on economic conditions or financial stability in the United States."

The Council appears to be a sort of expanded President's Working Group, consisting of the heads of various agencies and others. It would monitor the financial services industry, develop early warning systems, recommend coordinated actions, develop model supervisory policies, and make corrective action determinations. The Council would not have any independent supervisory or regulatory authority. The proposal for such a Council also raises unanswered questions about how such a group may interact with a systemic risk regulator for all systemically important financial companies, such as has been proposed by Treasury.

References

» National Insurance Consumer Protection Act (2009)

» Blueprint for a Modernized Financial Regulatory Structure (2008)

» National Insurance Act of 2007

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