

Financial Regulatory Reform: Important Developments for Insurance Companies

During the financial crisis, it became apparent that the regulatory framework for financial institutions had become obsolete. Although the capital markets had evolved and many market participants had changed over time, the regulations covering financial services had not kept pace with these developments. As a result, Congress passed the Wall Street Reform and Consumer Protection Act of 2010 (the “Dodd-Frank Act” or the “Act”), which was signed into law by President Obama on July 21, 2010. The Act is a sweeping financial regulatory reform bill intended to overhaul outdated rules, eliminate regulatory gaps, increase transparency, and reduce systemic risk.

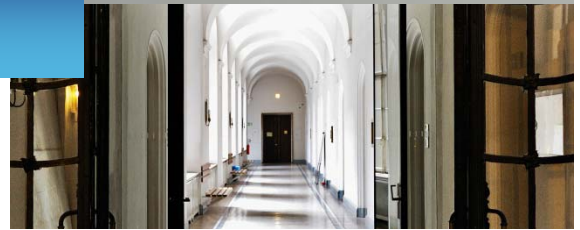
During this process, Congress considered the importance of, and the role played by, many different financial services entities, including banks, broker-dealers, insurance companies, asset managers, hedge funds, and private equity firms. The Act includes measures to monitor and regulate derivatives, private funds, and other financial products as well as the firms that use these products. For a detailed discussion of the Dodd-Frank Act and other reform initiatives, please refer to BlackRock’s *ViewPoint* “Fin Reg and Beyond: Global Implications for Investors.”

The insurance industry, which is currently regulated at the state level by commissioners, came under scrutiny in large part due to the role of AIG Financial Products in the crisis, and the realization that little was known about insurers at the national level. In response, the Act created the Federal Insurance Office (“FIO”) as a unit within the US Treasury Department. The FIO’s primary role is to inform the Administration and the Congress about matters pertaining to the insurance industry. In addition to creating the FIO, the Act established the Financial Stability Oversight Council (“FSOC”), an interagency body designed to promote market discipline and identify threats to financial stability.

The FSOC has many powers, including the ability to designate non-bank financial companies as systemically important financial institutions (“SIFIs”). SIFIs will be subject to prudential oversight by the Federal Reserve and will be required to file resolution plans with the Federal Deposit Insurance Corporation (“FDIC”). The FSOC, made up of ten voting members and five non-voting advisory members, has three seats reserved for representatives of the insurance industry. As illustrated by Figure 1, a voting membership is reserved for an independent representative of the industry, and non-voting memberships are reserved for the Director of the FIO and a state insurance commissioner. In September 2010, Director of the Missouri Department of Insurance John Huff was selected to fill one of the non-voting seats, and on March 17, 2011, Michael McRaith was chosen as the Director of the FIO, filling the other position. President Obama has yet to nominate a candidate for the voting seat, a position that will require Senate confirmation.

Insurance companies have many questions about the newly-established FIO, its director, and the future of financial regulatory reform and its impact on insurers. What are the powers of the FIO? Will the FIO become a federal regulator? Will there be an optional federal insurance charter? Will the FSOC designate insurance companies as SIFIs? Who is Michael McRaith and what are his positions on insurance issues? When will the final insurance seat on the FSOC be filled? This paper explores these questions.

The opinions expressed are as of March 2011 and may change as subsequent conditions vary.



Barbara Novick, Vice Chairman, is head of Government Relations and Public Policy.



Kristen M. Dickey, Managing Director, is head of BlackRock’s Financial Institutions Group within the Global Client Group.

Figure 1. Financial Stability Oversight Council Membership

Voting Members	
Secretary of Treasury	Timothy Geithner
Chairman of Federal Reserve	Ben Bernanke
Comptroller of the Currency	John Walsh
Chairman of SEC	Mary Schapiro
Chairman of FDIC	Sheila Bair
Chairman of CFTC	Gary Gensler
Director of Federal Housing Finance Agency	Edward DeMarco
Chairman of National Credit Union Administration Board	Deborah Matz
Representative of Bureau of Consumer Financial Protection	TBA
Representative of Insurance Industry	TBA
Non-Voting Advisory Members	
Director of the Office of Financial Research	TBA
Director of the Federal Insurance Office	Michael McRaith
A state insurance commissioner	John Huff
A state banking supervisor	William Haraf
A state securities commissioner	David Massey

Federal Insurance Office

The Federal Insurance Office was created with an explicit mandate to monitor the insurance industry and to collect data on insurance activities. This mandate reflects the concern of those in Washington who fear that more “AIGs” may be lurking in the shadows, posing threats to systemic stability. As further evidence of this concern, the Director of the FIO will advise the FSOC on the risks presented by insurers.

In recognition of the sensitivity surrounding the debate over federal versus state-level regulation, the FIO was not granted regulatory authority. In fact, the FIO is expected to work closely with the National Association of Insurance Commissioners (“NAIC”), and it is not authorized to pre-empt state regulation of insurance rates, premiums, underwriting practices, sales, solvency or anti-trust. Given the existing state regulatory framework, there has been no official US voice for international insurance matters. As a result, the FIO is tasked with the responsibility of representing the US at international meetings concerning insurance. The FIO can pre-empt state regulations in the case of international agreements. Please refer to Figure 2 for a comprehensive list of the powers and responsibilities held by the FIO.

The insurance industry is not united in its view of the FIO. Some have expressed concern about data collection burdens, however, the FIO is required to first utilize available public sources for information. That said, the FIO also has the authority to subpoena companies to provide data. Some companies, as well as state insurance commissioners, are concerned about federal policies superseding individual state policies. They point out that the insurance industry weathered the financial crisis better than the banking sector, and question the benefits of a federal regulator. On the other hand, some large national insurers, currently faced with the challenge of communicating with multiple state commissioners and complying with multiple state regulations, welcome the idea of an optional federal charter. Most within the industry agree that the FIO can play a constructive role in promoting uniformity in regulatory practices and providing a voice in international forums.

While it is too early to speculate about how the FIO might evolve, the Act requires the FIO to report to Congress by February 2012 on how insurance regulation could be improved and modernized. The report must address: (i) costs and benefits of potential federal regulation of insurance, (ii) feasibility of regulating only certain lines at the federal level, (iii) current or potential regulatory arbitrage (iv) developments in the international regulation of insurance, (v) potential consequences of subjecting insurance companies to a federal resolution authority, and (vi) issues related to consumer protection.

Financial Stability Oversight Council

One of the most controversial elements of the Dodd-Frank Act is the designation of non-bank financial institutions as SIFIs and the subjection of them to bank-like regulations. In recent months, insurers have expressed great concern that the lack of insurance representation and expertise on the FSOC may be disadvantageous. In a comment letter submitted by the American Insurance Association (AIA), the American Council of Life Insurers (ACLI), and the Reinsurance Association of America (RAA), industry representatives “jointly urge the Council both to defer further action on the [notice of proposed rulemaking] as applied to insurers until such time as the full complement of voting and non-voting insurance members of the Council are in place and to stay further consideration of any application of the Section 113 regulations to insurance companies until industry-specific standards have been developed and public input received.”¹ Likewise, the Property Casualty Insurers Association of America (PCI) points out that “The Council is conducting its work without the participation of an independent insurance expert (to be appointed by the President) or the Director of Federal Insurance Office (to be appointed by the Treasury Secretary).”² While the recent appointment of Michael McRaith

¹ Letter from American Insurance Association (AIA), American Council of Life Insurers (ACLI), and Reinsurance Association of America (RAA) to Financial Stability Oversight Council dated February 9, 2011

² Letter from Property Casualty Insurers Association of America to Financial Stability Oversight Council dated February 25, 2011

Figure 2. Dodd-Frank Act Responsibilities of Federal Insurance Office

- ▶ Monitoring all aspects of the insurance industry, including identifying gaps in regulation that could contribute to a systemic crisis in the industry or the broader financial system.
- ▶ Collecting and disseminating data (statistical and otherwise) on insurance activity.
- ▶ The FIO will advise the Treasury Secretary on major domestic and prudential international insurance policy issues.
- ▶ Recommending to the FSOC any insurers that should be treated as systemically important financial institutions (SIFIs). The Director of the FIO will serve in an advisory capacity as a non-voting member of the FSOC.
- ▶ Representing the US in the International Association of Insurance Supervisors, and determining whether state insurance provisions should be pre-empted by international agreements.
- ▶ Monitoring the extent to which traditionally underserved consumers have access to affordable insurance products.
- ▶ Assisting the Treasury Secretary in administering the Terrorism Insurance Program.
- ▶ Delivering an annual report to Congress on the insurance industry as well as any actions taken by the FIO regarding pre-emption of inconsistent state insurance measures.
- ▶ Delivering a special report to Congress by February 2012 on improving and modernizing insurance regulation.
- ▶ Delivering a special report to Congress by September 2012 on the breadth and scope of the global reinsurance market.
- ▶ Delivering a special report to Congress by January 2015 on the impact of Part II of the Non-admitted and Reinsurance Reform Act of 2010 on state regulators.

as FIO Director fills one of the remaining seats, the third is still vacant. Approval for this position requires Senate confirmation, often a lengthy process. At this point, it is unclear whether the FSOC will proceed in their deliberation on insurance-related issues or wait for the voting member to be confirmed.

Insurance companies have raised many objections to the potential SIFI designation. Insurers are highly regulated by their primary regulators; they are subject to strict risk-based capital and reserving requirements, accounting and underwriting requirements, and financial reporting requirements. At the state level, there are also insurance guaranty funds. In addition, insurers note that they are not interconnected with other financial firms, they have low leverage, and they are not associated with “run on the bank” scenarios. In the current insurance marketplace, there are many competitors and relatively little concentration risk. Finally, as the AIA points out, if insurers are designated, there exists a potential for “adverse consequences, including non-risky insurers being assessed to bail out far more systemically risky institutions, the imposition of significant and unproductive new layers of financial regulation and associated supervisory compliance costs, and increased capital requirements that are tailored to bank holding companies, not operating insurance companies.”³

Michael McRaith Appointed FIO Director

At the March 17 meeting of the FSOC, Treasury Secretary Geithner announced the appointment of Michael McRaith as the first Director of the FIO. Prior to his appointment, Mr. McRaith had served as the Director of Insurance for the State of Illinois and had acted as a spokesman for the NAIC. Although he is a Washington outsider and has never been employed by an insurance company, Mr. McRaith’s experience as a private practice attorney, a state insurance commissioner, and an NAIC representative qualify him for the position, in our view. We hope that Mr. McRaith will bring a balanced perspective to the FIO and will serve as a mediator between insurance companies, state regulators, and proponents of federal-level industry regulation.

While Mr. McRaith’s views may evolve, in his March 17, 2009 testimony on behalf of the NAIC to the US Senate,⁴ he clearly laid out the case for a state-based regulatory framework.

McRaith stated support for the status quo regarding state regulation of the insurance industry:

“Any reforms to functional insurance regulation should start and end with the States. Federal assistance may be necessary if targeted to streamline insurance regulator interaction and coordination with other functional regulators, but that initiative should not supplant or displace the state regulatory system.”

³ Letter from American Insurance Association (AIA) to Financial Stability Oversight Council dated February 25, 2011

⁴ Testimony of the National Association of Insurance Commissioners Before the Committee on Banking, Housing and Urban Affairs, United States Senate, Regarding: “Perspectives on Modernizing Insurance Regulation” Tuesday, March 17, 2009

McRaith expressed concern about the creation of an optional Federal charter:

“While contemplating perspectives on insurance regulatory reform, a group of the world’s largest insurers continue to advocate for parallel Federal and state regulation. For more than ten years, insurance industry lobbyists have called for the creation of a massive new Federal bureaucracy known as an optional Federal charter (“OFC”). The current climate of instability and insolvency in the banking sector illustrates this concept cannot work. An optional system where the regulated enterprise chooses the regulator with the lightest touch – as evidenced by AIG – leads to regulatory arbitrage, gaps in supervision, ineffective risk management and disastrous failures. Through the OFC, some of the largest insurers seek to unravel basic consumer protections and the essential solvency requirements that have nurtured the world’s largest and most competitive insurance markets. The State-based system benefits both consumers and industry participants. The facts do not support the need for an OFC – it is a solution in search of a problem.”

McRaith indicated that he does not view insurance companies as the catalyst of systemic risk:

“State insurance regulators support Federal initiatives to identify and manage national and global systemic risk....Insurance is one part of a far larger financial services economic sector. Insurance companies are not likely to be the catalyst of systemic risk but, rather, the unfortunate recipient of risk imposed by other financial sectors .”

Conclusion

The Dodd-Frank Act is a first step towards financial regulatory reform. Although the Act falls short of creating a federal insurance regulator, clearly all financial services companies, including insurance companies, should expect greater scrutiny. In our opinion, the FIO should provide a window into the industry and should enable federal legislators and regulators to develop balanced views. The FSOC’s view of the insurance industry and the potential designation of insurers remain unknown at this point. The appointment of Michael McRaith as Director of FIO establishes a strong “state” voice, however, this may change as the process evolves. We will continue to monitor legislative and regulatory developments as they pertain to the insurance industry.

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