

ALERTS AND UPDATES

U.S. Financial Reform: Creation of the Federal Insurance Office and the Financial Stability Oversight Council

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The Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 ("the Act") begins sweeping reform for the U.S. financial system. It requires new and existing regulatory agencies to undertake more than 50 studies of the financial system and more than 250 instances of rulemaking. Duane Morris has issued further Alerts on many of the broad topics addressed by the Act, accessible at www.duanemorris.com/FinancialReform.

Title V of the Act, designated the Federal Insurance Office Act of 2010, creates a new office within the U.S. Department of the Treasury (the "Department"), known as the Federal Insurance Office (FIO), which will be focused solely on the insurance industry, will act as the monitor of systemic risk within that industry and will provide for certain reforms to state practices concerning nonadmitted insurance and reinsurance. Title V also creates a nine-member Financial Stability Oversight Council, led by the Secretary of the Treasury, charged with monitoring systemic risk for the overall U.S. financial system. After the defaults in the insurance industry in 2008 and the subsequent bailouts by taxpayers, Congress became concerned that insurance oversight by the states was ineffective and needed help from the federal government. This *Alert* discusses the impact of Title V on the insurance industry and highlights its most significant provisions.

Title V's Impact on the Insurance Industry

While the advent of the FIO signals the federal government's involvement in the insurance industry, the FIO, at this time, principally serves to monitor, collect and report on the industry without the authority to act unilaterally. In this limited capacity, the FIO presents an additional layer of inspection of the insurance industry, falling short of an outright interference in the way in which insurers conduct business. It remains to be seen how far Congress may seek to expand the FIO's authority in the coming years and whether the FIO will emerge as a regulatory body.

Subtitle B assigns primary authority to the home state in transactions concerning nonadmitted insurance (of the insured) and the domiciliary state in those transactions concerning reinsurance (of the reinsurer), which underscores Congress' objective of creating universal and uniform practices in these areas.

Subtitle A: The Federal Insurance Office Act of 2010

The Secretary of the Treasury (the "Secretary") is tasked with appointing the Director of the FIO (the "Director"). The FIO is permitted to utilize resources available to the Secretary, including personnel so designated by the Secretary.

The FIO's Functions

Under section 313(c), the FIO, as directed by the Secretary, is endowed with a host of authoritative and advisory functions. The FIO has the authority to:

- Monitor the insurance industry, including the assessment of potential systemic crisis within the industry or the U.S. financial system;
- Monitor certain underserved communities' and consumers' access to affordable insurance products (with the exception of health insurance);
- Recommend that an insurer (and its affiliates) be subjected to regulation by the Board of Governors of the Federal Reserve System through designation as a nonbank financial company by the Financial Stability Oversight Council;
- Assist the Secretary with the administration of the Terrorism Insurance Program established by the Terrorism Risk Insurance Act of 2002;
- Address international insurance matters through coordination of federal endeavors, development of federal policy, representation in the International Association of Insurance Supervisors and assistance to the Secretary in the negotiation of covered agreements;
- Render preemption determinations vis-à-vis the states;
- Consult on insurance issues of national and international importance with the states; and
- Perform any other duties and authorities assigned by the Secretary.

The FIO's advisory functions, set forth in section 313(c)(2), include advising the Secretary on both domestic and international insurance policy issues. In addition, the Director is tasked with advising the Financial Stability Oversight Council.

In order to perform these functions, the FIO is permitted to obtain data and information from the insurance industry, insurers and affiliates – with the exception of certain small insurers and their affiliates – and analyze and disseminate such data and information. To this end, the FIO is given the power to subpoena and, if necessary, enforce the subpoena in the appropriate U.S. district court. The agency disclosure requirements set forth in 5 U.S.C. § 552, which governs "Public information; agency rules, opinions, orders, records, and proceedings," apply to any data or information provided by insurers or affiliates of the FIO. To further these endeavors, the FIO may become party to information-sharing agreements with state insurance regulators as long as such agreements comply with federal law and do not waive or affect federal or state privileges with respect to the shared information. The FIO may also issue reports as necessitated by the aforementioned functions.

In an effort to protect insurers and affiliates from potentially burdensome data collections, the FIO is required to first pursue the data and information through public channels, such as the appropriate federal agency and state insurance regulator and any other publicly available source. Only after consulting these sources and upon the Director's determination that such data and information are publicly unavailable, may the Director seek the data and information from the insurer and affiliate, subject to the requirements of the Paperwork Reduction Act. In the event the insurer or affiliate produces nonpublicly available data or information to the FIO, such production would neither impact any applicable federal or state privilege nor would it impact any confidentiality agreement already in place.

The FIO's Scope

The scope of the FIO's authority is quite broad and limited only to the extent provided in section 313(d), which excepts health insurance, long-term care insurance that is not bundled with life or annuity insurance, and crop insurance from the FIO's authority.

The FIO's Impact on the States' Insurance Measures

The Director is responsible for making preemption determinations where a state insurance measure is less favorable to a non-U.S. insurer subject to a covered agreement than a U.S. insurer and an inconsistency exists with the covered agreement, subject to certain delineated limitations. The Director is not authorized to preempt state measures governing rates, premiums, underwriting or sales practices; coverage requirements; applications of antitrust laws; or capital or solvency measures (except to the extent such measure is more favorable to a U.S. insurer).

Covered agreements are agreements on insurance or reinsurance matters, entered into and negotiated by the Secretary and U.S. Trade Representative on behalf of the United States, between the United States and foreign government(s), authority(ies) or regulatory entity(ies) that provide protection to consumers similar to state insurance or reinsurance regulations. Title 31, section 321(a) of the U.S. Code has been amended to include a provision that requires that the Secretary advise the President on domestic and international insurance policy issues.

Section 313(f)(2) sets forth the procedure to be followed by the FIO in the event of a possible preemption. Prior to making a preemption determination, the Director is required to notify and consult with the state and the U.S. Trade Representative, publish a *Federal Register* notice, provide interested parties time to submit comments to the FIO and consider any such comments. In the event that the Director decides there is an inconsistency warranting preemption, the Director is required to notify the state, set a reasonable period of time prior to the effective date, and notify the U.S. House of Representatives (Committees on Financial Services, and Ways and Means) and the Senate (Committees on Finance and on Banking, Housing and Urban Affairs). At the conclusion of the period designated by the Director, assuming the inconsistency still exists, the determination becomes effective and the Director is required to notify the state and publish notice of the preemption in the *Federal Register*.

However, states retain their general supervisory or regulatory authority of the insurance business. In addition, the federal financial regulatory agencies and the U.S. Trade Representative retain their previously existing authority, among other things, to develop and coordinate policy (including international trade policy), negotiate with foreign governments and regulatory entities, and ensure uniformity on international regulatory agreements through preemption.

The FIO's Reporting Responsibilities

The Director is required to report annually all preemption actions to the President, the House of Representatives (Committees on Financial Services, and Ways and Means) and the Senate (Committees on Finance and on Banking, Housing and Urban Affairs). In addition, the Director is required to submit an annual report on the insurance industry to the President, the House of Representatives (Committee on Financial Services) and the Senate (Committee on Banking, Housing and Urban Affairs) and respond to any committee questions.

The Director is also tasked with reporting on the global reinsurance market and the impact of Part II (Reinsurance) of the Nonadmitted and Reinsurance Reform Act of 2010 by dates set forth in section 313(o).

Finally, the Director is commissioned to study and report on ways to modernize and improve insurance regulation.

Subtitle B: State-Based Insurance Reform

The Nonadmitted and Reinsurance Reform Act of 2010 ("Subtitle B") will become effective, if not otherwise so specified, 12 months following enactment of the Act.

Part I: Nonadmitted Insurance

Section 527(11) defines a "nonadmitted insurer" as "an insurer not licensed to engage in the business of insurance in [a] State but. . . does not include a risk retention group."

Pursuant to section 521(a), the home state of the insured has exclusive authority to require a premium tax payment on nonadmitted insurance, because the home state of the insured would presumably bear the financial responsibility if the insurer defaulted. The allocation of premium taxes on nonadmitted insurance may be established by a compact among the states. It appears to be Congress' intent for a nationwide system to be adopted for reporting, payment, collection and allocation for nonadmitted insurance.

In addition, pursuant to section 522, the home state of the insured has exclusive authority over the placement of nonadmitted insurance and governs the licensing of surplus lines brokers. State laws, rules or regulations that limit the placements of workers' compensation insurance or excess insurances for self-funded workers' compensation plans with nonadmitted insurers' are expressly not preempted by section 522.

Section 523 requires states to participate in the national insurance producer database of the National Association of Insurance Commissioners (NAIC) within two years following enactment of Subtitle B. In the event a state fails to participate, the state is prohibited from collecting fees related to licensing surplus line brokers.

Section 524 prohibits states from imposing nonadmitted insurer eligibility requirements that do not conform with the Non-Admitted Insurance Model Act unless the state has adopted the nationwide system set forth in section 521(b)(4). Furthermore, section 524 prohibits states from refusing to allow surplus line brokers to place or procure nonadmitted insurance from a nonadmitted insurer listed on the NAIC's Quarterly Listing of Alien Insurers.

Section 525 governs the procurement and placement of nonadmitted insurance by surplus line brokers for purchasers who are deemed "exempt commercial purchasers" under section 527(5). Such applications for nonadmitted insurance are streamlined in that they do not require the surplus line broker to first conduct a due diligence search of admitted insurers as long as the surplus line broker discloses the availability of admitted insurers and the exempt commercial purchaser confirms in writing the request for nonadmitted insurance.

Section 526 requires that the Comptroller General of the United States, in consultation with the NAIC, complete a study of the nonadmitted insurance market, which will be submitted to the Senate Committee on Banking, Housing, and Urban Affairs and the House of Representatives Committee on Financial Services within 30 months of the effective date of Subtitle B.

Section 527 provides the definitions applicable to part I of Subtitle B.

Part II: Reinsurance

Section 531 governs credit for reinsurance and provides that as long as a ceding insurer's domiciliary state is NAIC-accredited or has similar financial solvency requirements, credit may not be denied for reinsurance by any other state. A nondomiciliary state's laws, regulations, provisions and other actions concerning reinsurance contractual disputes are preempted, with the exception of certain taxes and assessments.

Section 532 addresses the regulation of financial solvency of reinsurers, which rests in the province of the reinsurer's domiciliary state, as long as that state is NAIC-accredited or has similar solvency requirements. Where the reinsurer's domiciliary state is vested with such accreditation or similar solvency requirements, no other state is permitted to require the production of any additional financial information from the reinsurer. However, nondomiciliary states may receive a copy of the financial statement filed by the reinsurer with its domiciliary state.

Section 533 provides the definitions applicable to part II of Subtitle B.

Part III: Rule of Construction

Any conflicts between Subtitle B and antitrust laws will be resolved in favor of the antitrust laws. In addition, the sections and subsections of Subtitle B are severable in the event that a portion therein is deemed unconstitutional.

About Duane Morris

Duane Morris has an online **Financial Services Reform Center** – www.duanemorris.com/FinancialReform – which includes videos and the firm's comprehensive series of *Alerts* analyzing the provisions of the Act and emerging policies, as well as links to relevant government websites. Duane Morris' attorneys will be monitoring the rules and regulations released under the Act, as well as the regulatory agencies' interpretive guidance. For [subsequent Alerts](#) on these and other topics, please revisit www.duanemorris.com and www.duanemorris.com/FinancialReform.

For Further Information

If you have any questions about the Act or any of the topics described in this *Alert*, including how they may affect your company or its executives, please contact [Eberhard H. Röhm](#), [Ingrid E. Melnichuk](#), any [member](#) of the [Corporate Practice Group](#) or the attorney in the firm with whom you are most regularly in contact.

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