



Insurance and Financial Regulatory Reform in the 111th Congress

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January 13, 2010

Congressional Research Service

7-5700

www.crs.gov

R41018

Summary

In the aftermath of the recent financial crisis, broad financial regulatory reform legislation has been advanced by the Obama Administration and by various Members of Congress. Under the McCarran-Ferguson Act of 1945, insurance regulation is generally left to the individual states. For several years prior to the financial crisis, some Members of Congress have introduced legislation to federalize insurance regulation along the lines of the regulation of the banking sector, although none of this legislation has reached the committee markup stage.

The financial crisis, particularly the role of insurance giant AIG and the smaller monoline bond insurers, changed the tenor of the debate around insurance regulation, with increased emphasis on the systemic importance of insurance companies. While it could be argued that insurer involvement in the financial crisis demonstrates the need for full-scale federal regulation of insurance, to date the broad financial regulatory reform proposals have not included language implementing such a system. Instead, broad reform proposals have tended to include the creation of a somewhat narrower federal office focusing on gathering information on insurance and setting policy on international insurance issues. Legislation proposed by the Obama Administration, Representative Paul Kanjorski (H.R. 2609 as incorporated into H.R. 4173), Representative Spencer Bacchus (H.Amdt. 539 to H.R. 4173), and Senator Christopher Dodd (committee print of the Restoring American Financial Stability Act of 2009), all contain slightly differing versions of such an office.

The broad reform proposals could also affect insurance through consumer protection or systemic risk provisions, though insurance is largely exempted from these aspects of the legislation as well. The Obama proposal exempts insurance from the proposed federal consumer protection agency's oversight, except for title, credit, and mortgage insurance. Insurers could be considered "tier 1 financial holding companies" and thus subject to Federal Reserve oversight and federal resolution authority. Representative Barney Frank's H.R. 4173 as passed by the House exempts all insurance from the federal consumer protection agency's purview. In limited circumstances, insurers under H.R. 4173 could be subject to additional regulation for systemic stability and federal resolution authority, although insurers would continue to be primarily subject to state guaranty fund resolution. Under Senator Dodd's committee print, systemically significant insurers could be subject to the new Agency for Financial Stability and federal resolution authority.

Finally, H.R. 4173 and the Dodd committee print include narrower insurance reform legislation regarding surplus lines insurance and reinsurance similar to H.R. 2572/S. 1363, which had previously passed the House.

The House of Representatives passed H.R. 4173 on December 11, 2009, by a vote of 223-202. The Senate Banking, Housing, and Urban Affairs Committee held a hearing on Senator Dodd's committee print on November 19, 2009, but has not officially acted further on the legislation.

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Under the McCarran-Ferguson Act of 1945,¹ insurance regulation is generally left to the individual states. For several years prior to the recent financial crisis, some Members of Congress have introduced legislation to federalize insurance regulation along the lines of the regulation of the banking sector, although none of this legislation has reached the committee markup stage.² Various other pieces of legislation have also been introduced to reform insurance regulation in more narrow ways.³ The debate around federal involvement in insurance regulation had traditionally focused on the negative and positive aspects of the state-centered approach compared to increased federal government involvement.

The financial crisis, particularly the involvement of insurance giant AIG and the smaller monoline bond insurers, changed the tenor of the debate around insurance regulation, with increased emphasis on the systemic importance of insurance companies. While it could be argued that insurer involvement in the financial crisis demonstrates the need for full-scale federal regulation of insurance, to date the broad financial regulatory reform proposals have not tended to include language implementing such a system. Instead, such proposals have tended to include the creation of a narrower federal office focusing on gathering information on insurance and setting policy on international insurance issues. The broad reform proposals could also potentially affect insurance through consumer protection or systemic risk provisions, though insurance is largely exempted from these aspects of the legislation as well.

Insurance and the Financial Crisis

The recent financial crisis grew largely from sectors of the financial industry that had previously been perceived as presenting little systemic risk. Many see the crisis as resulting from failures or gaps in the financial regulatory structure, particularly a lack of oversight for the system as a whole and a lack of coordinated oversight for the largest actors in the system.⁴ This has increased the urgency in calls for overall regulatory changes, such as the implementation of increased systemic risk regulation and federal oversight of insurance, particularly larger insurance firms. Generally good performance of insurers in the crisis, however, has also provided additional arguments for those seeking to retain the state-based insurance system.

Although insurers in general appear to have weathered the financial crisis reasonably well, the insurance industry has seen two significant failures, one general and one specific. The first failure involved financial guarantee or monoline bond insurers. Before the crisis, there were only about a dozen bond insurers in total, with four large insurers dominating the business. This type of insurance originated in the 1970s to cover municipal bonds, but the insurers expanded their businesses since the 1990s to include significant amounts of mortgage-backed securities. In late 2007 and early 2008, strains began to appear due to exposure to mortgage-backed securities. Ultimately some smaller bond insurers failed and the larger insurers saw their previously triple-A credit ratings downgraded significantly. These downgrades rippled throughout the municipal bond

¹ 15 U.S.C. Sec. 1011 *et seq.*

² See CRS Report RL34286, *Insurance Regulation: Federal Charter Legislation*, by Baird Webel.

³ See CRS Report R40771, *Insurance Regulation: Issues, Background, and Legislation in the 111th Congress*, by Baird Webel.

⁴ See, for example, the remarks by SEC Chairman Mary L. Shapiro from the University of Rochester's Presidential Symposium on the Future of Financial Regulation, available at <http://www.sec.gov/news/speech/2009/spch101009mls.htm>.

markets, causing unexpected difficulties for both individual investors and municipalities who might have thought they were relatively insulated from problems stemming from rising mortgage defaults.

The second failure in the insurance industry was that of a specific company, AIG.⁵ AIG had been a global giant of the industry, but it essentially failed in mid-September 2008. To avoid bankruptcy in September and October 2008, AIG was forced to seek more than \$100 billion in assistance from, and give 79.9% of the equity in the company to, the Federal Reserve. Multiple restructurings of the assistance have followed, including up to \$70 billion through the U.S. Treasury's Troubled Asset Relief Program (TARP). AIG is currently in the process of selling off parts of its business to pay back assistance that it has received from the government; how much value will be left in the 79.9% government stake in the company at the end of the process remains an open question.

The near collapse of the bond insurers and AIG could be construed as regulatory failures. One of the responsibilities of an insurance regulator is to ensure that insurers remain solvent and are able to pay future claims. Because the states are the primary insurance regulators, some may go further and argue that these cases specifically demonstrate the need for increased federal involvement in insurance. The case of AIG, however, is a complicated one. AIG was primarily made up of state-chartered insurance subsidiaries, but the state insurance regulators did not oversee the entire company. At the holding company level, AIG was a federally regulated thrift holding company and thus overseen by the Office of Thrift Supervision (OTS). The immediate losses that caused AIG's failure came from both derivatives operations overseen by OTS and from securities lending operations that originated with securities from state-chartered insurance companies. OTS has claimed that it had sufficient regulatory authority and competence to oversee a complicated holding company such as AIG. Others, particularly the Federal Reserve, have disputed this claim and argue that a single body is needed to oversee systemic risk and large financial holding companies.

Insurance and Financial Regulatory Reform Proposals

2008 Treasury Blueprint

In March 2008, then-Secretary of the Treasury Henry Paulson released a "Blueprint for a Modernized Financial Regulatory Structure." Although the financial crisis had begun at that time, the Treasury blueprint was not in the first instance a response to the crisis, but instead an attempt to create "a more flexible, efficient and effective regulatory framework."⁶ A wide-ranging document, the blueprint foresaw a completely revamped regulatory structure for all financial services.

⁵ See CRS Report R40438, *Ongoing Government Assistance for American International Group (AIG)*, by Baird Webel.

⁶ U.S. Treasury, "Treasury Releases Blueprint for Stronger Regulatory Structure," press release, March 31, 2008, <http://www.ustreas.gov/press/releases/hp896.htm>.

The 2008 Treasury model ultimately would have resulted in a prudential regulator overseeing the solvency of individual companies, a business conduct regulator overseeing consumer protection, and a market stability regulator overseeing risks to the entire system. As an intermediate step, it made two specific recommendations on insurance regulation. First, it called for the creation of a federal insurance regulator to oversee an optional federal charter for insurers as well as federal licensing for agents and brokers. Second, recognizing that the debate over an optional federal charter is ongoing in Congress, it recommended the creation of an “Office of Insurance Oversight” in the Department of the Treasury as an interim step. This office would be charged with two primary functions: (1) dealing with international regulatory issues, including the power to preempt inconsistent state laws, and (2) collecting information on the insurance industry and advising the Secretary of the Treasury on insurance matters.

President Obama’s Financial Regulatory Reform Plan

In June 2009, the Treasury Department under Secretary Timothy Geithner released a white paper entitled “Financial Regulatory Reform: A New Foundation,” outlining President Obama’s plan to reform financial regulation in the United States.⁷ Since the release of the overall plan, legislative language to implement the plan has also been released by the Treasury. The plan does not foresee a complete reinvention of the financial regulatory system, but it would substantially change it. Specific changes called for include explicitly introducing systemic risk oversight by the Federal Reserve and a newly created council of regulators, combining the Office of the Comptroller of the Currency and the Office of Thrift Supervision into a single banking regulator, and creating a new Consumer Financial Protection Agency (CFPA).

Although the June white paper states that the Administration is open to additional changes in the insurance regulatory system, the specific regulatory changes called for in the released legislative language primarily addressed areas other than insurance. Insurance would be primarily affected through three aspects of the proposal: the creation of a federal consumer protection agency, the regulation of large financial companies presenting systemic risk, and the creation of a new Office of National Insurance within the Treasury.

As proposed by the Administration, the CFPA would have broad authority over a wide array of financial services, particularly deposit taking, mortgages, credit cards, and other loans. In the realm of insurance, however, its powers would be limited, with the states retaining their preeminent role. The sole insurance lines to be overseen by the federal agency would be credit, title, and mortgage insurance.

Systemic risk regulation as proposed in the Administration’s legislation would be the primary responsibility of the Federal Reserve in conjunction with a new Financial Services Oversight Council, made up of the heads of most of the federal financial regulators. The powers to regulate for systemic risk enumerated in the draft legislation extend to all companies in the United States that engage in financial activities. Although the draft legislation does not specifically name insurers as subject to federal systemic risk regulation, it would seem to include them under potential federal jurisdiction. Companies whose failure might affect global or U.S. financial stability may be designated Tier 1 Financial Holding Companies and be subject to stringent solvency standards and additional examinations. Such companies would also be subject to

⁷ See the U.S. Treasury website: <http://ustreas.gov/initiatives/regulatoryreform/>.

enhanced resolution authority rather than standard bankruptcy provisions, allowing the FDIC to take them into conservatorship or receivership. Although the draft language does make reference in some places to state functional regulatory agencies, it is unclear exactly how the Federal Reserve as regulator of the financial holding company would interact with the state regulators of the individual insurance subsidiaries. Under the current regulatory system, where there are some federally regulated holding companies that are primarily insurers, the federal regulators generally defer to the state insurance regulators. Whether this deferral would continue under the new proposed legislation remains an open question.

Although systemic risk regulation and consumer protection would likely apply to a relatively small number of insurers, the proposed creation of an Office of National Insurance could have a broader impact. Unlike the similarly named office in other legislation, such as H.R. 1880, the Office of National Insurance in the Administration proposal would not oversee a federal insurance charter or have direct regulatory power over insurers. Rather, this office would operate as a broad overseer and voice for insurance at the federal level, including collecting information on insurance issues, setting federal policy on insurance, representing the United States in international insurance matters, and preempting some state laws where these laws are inconsistent with international agreements. The Administration's office would have subpoena power to require an insurer to submit information in addition to collecting public information.

House Legislation (H.R. 2609/H.R. 3126/H.R. 3996/H.R. 4173)

In July 2009, the House Financial Services Committee began marking up bills that were broadly similar to the regulatory reform proposals of the Obama Administration. As in the Administration proposals, there were three primary ways that insurance might be affected by the legislation: a new federal insurance office (H.R. 2609), a new consumer financial protection agency (H.R. 3126), and provisions to address systemic risk (H.R. 3996). Once these markups were complete, a new bill (H.R. 4173) was introduced incorporating the committee work. When H.R. 4173 was considered on the House floor, an amendment was passed adding the Nonadmitted and Reinsurance Reform Act of 2009 (H.R. 2571), a previously passed narrower bill addressing surplus lines and reinsurance. The individual issues are detailed below.

Federal Insurance Office

In April 2008, Subcommittee Chairman Paul Kanjorski introduced the Insurance Information Act of 2008, a bill to create an office similar to that foreseen in the 2008 Treasury proposal. After being amended in subcommittee markup, the bill did not advance further in the 110th Congress. Representative Kanjorski reintroduced the bill in the 111th Congress as H.R. 2609. Different discussion drafts were released before the bill was ultimately amended in full Financial Services Committee markup on December 2, 2009. The text of H.R. 2609 as amended was incorporated as Title VI of H.R. 4173 as introduced by House Financial Services Committee Chairman Barney Frank. Among the amendments was a title change to the "Federal Insurance Office Act of 2009."

The language in H.R. 4173 is broadly similar to the concept originally proposed by the Treasury in 2008, namely an office to collect information and gain expertise about the insurance industry while acting as a voice for federal policy in insurance, including the authority to preempt state laws when these conflict with international agreements. The details of the specific language, however, have changed through the process, with the final congressional language tending to reduce the Federal Insurance Office's (FIO) authority as compared to that put out by the

Administration. For example, the FIO in H.R. 4173 would not have the subpoena authority previously mentioned. H.R. 4173 would also include in international negotiations the United States Trade Representative (USTR), not just the FIO, and require a 90-day delay for congressional consideration when agreements are completed.

Federal Consumer Financial Protection Agency

The original bill to create a federal Consumer Financial Protection Agency (H.R. 3126) followed the Obama Administration proposal closely. With regard to insurance, it would have exempted most lines of insurance from the CFPA, except for title, credit, and mortgage insurance. H.R. 4173 as it passed the House, however, does not authorize the CFPA to cover any lines of insurance. This is the outcome of the Financial Services Committee markup where an amendment by Representatives Gwen Moore and Erik Paulsen exempted title, credit, and mortgage insurance from CFPA authority.

Systemic Risk Provisions

The systemic risk aspects contained in H.R. 4173 would affect insurance primarily through oversight of firms deemed systemically significant and through specific financial resolution authority. Systemic risk regulation would be the primary responsibility of the Federal Reserve, in conjunction with a new Financial Services Oversight Council made up of the heads of most of the federal financial regulators. The oversight council is also to include one state insurance commissioner as a non-voting member. The power to regulate for systemic risk enumerated in the legislation extends to all companies in the United States engaged in financial activities. A company whose failure is judged to be a possible threat to global or U.S. financial stability may be designated a “financial holding company subject to stricter standards.” This designation is to be made by the oversight council in consultation with a company’s primary regulator, with the state insurance regulators being specifically named in the legislation. Such holding companies would be subject to more stringent solvency standards and to additional examinations.

Financial holding companies subject to stricter standards would also be subject to enhanced dissolution authority rather than to standard bankruptcy provisions. H.R. 4173 makes it clear, however, that insurers are primarily to be resolved through the existing state bodies, the insurance guaranty funds. Financial companies with assets exceeding \$50 billion are subject to assessments in order to fund the dissolution authority. This fund is to be created prior to failure, up to a limit of \$150 billion.

Surplus Lines and Reinsurance

Originally introduced and passed in the 109th Congress, the Nonadmitted and Reinsurance Reform Act (H.R. 2571 in the 111th Congress), passed the House in the 111th Congress as a standalone bill on September 10, 2009. The rule governing floor consideration of H.R. 4173 allowed Representatives Dennis Moore and Scott Garrett to offer the text of H.R. 2571 as an amendment. Their amendment was incorporated into an en bloc amendment (H.Amdt. 529) offered by Representative Barney Frank. This en bloc amendment passed by voice vote.

This bill would address a relatively narrow set of insurance regulatory issues. In the area of nonadmitted (or “surplus lines”) insurance, the bills would harmonize, and in some cases reduce, regulation and taxation of this insurance by vesting the “home state” of the insured with the sole

authority to regulate and collect the taxes on a surplus lines transaction. Those taxes that would be collected may be distributed according to a future interstate compact, but absent such a compact their distribution would be within the authority of the home state. This bill would also preempt any state laws on surplus lines eligibility that conflict with the National Association of Insurance Commissioners (NAIC) model law and would implement “streamlined” federal standards allowing a commercial purchaser to access surplus lines insurance. For reinsurance transactions, it would vest the home state of the insurer purchasing the reinsurance with the authority over the transaction while vesting the home state of the reinsurer with the sole authority to regulate the solvency of the reinsurer.

Senator Dodd’s Committee Print

In November 2009, Chairman Christopher Dodd of the Senate Committee on Banking, Housing, and Urban Affairs released a committee print of the Restoring American Financial Stability Act of 2009. The committee held a hearing on the bill on November 19, 2009. Following this hearing, bipartisan groups of Senators are reportedly meeting to develop further approaches to regulatory reform prior to committee markup.⁸ The following discusses the committee print released by Senator Dodd.

Senator Dodd’s committee print differs significantly from both the Obama proposal and H.R. 4173. In particular, Senator Dodd’s proposal departs from the previous proposals in its combination of five current banking regulators into a single regulator and its addressing of systemic risk through a single Agency for Financial Stability. The actual effect on insurance of the Dodd committee print, however, may not be as different as Dodd’s plan would be for other financial sectors. As with H.R. 4173, the Dodd committee print would create a Consumer Financial Protection Agency, but insurance would be largely outside of its purview. Large, systemically significant financial companies would face heightened prudential standards set by the agency, whereas in H.R. 4173, these standards would be set by the Federal Reserve. Day-to-day regulation of insurers is left to the states as in the current system. Large systemically significant financial companies would be required to submit resolution plans in the case of their failure and the FDIC would have the responsibility of resolving such firms. This resolution would be paid for with after-the-fact assessments on firms with assets over \$10 billion. The Dodd committee print includes an “Office of National Insurance” in Treasury, similar to the Federal Insurance Office in H.R. 4173, and also includes language on surplus lines and reinsurance very similar to that added to H.R. 4173 on the House floor.

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⁸ See, for example, “Senate Panel Eyes Next Month To Mark Up Regulatory Bill,” *CongressDaily*, December 16, 2009.