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Insurance and Financial Regulatory Reform in the 111th Congress

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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), and Senator Christopher Dodd (S. 3217), 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 whereas Representative Barney Frank's H.R. 4173 as passed by the House exempts all insurance from the federal consumer protection agency's purview and S. 3217 would do so as well. In all three proposals, large insurers could be considered systemically significant and be subject to oversight by a systemic risk council and the Federal Reserve as well as federal resolution authority.

H.R. 4173 and S. 3217 also include narrower insurance reform language 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 considered S. 3217 through April and May 2010. On May 20, 2010, the Senate finished the amendment process to S. 3217, substituted this bill as amended into H.R. 4173, and passed the Senate version of H.R. 4173 by a vote of 59-39.

The conference committee on H.R. 4173 added an amendment by Senator Tom Harkin involving Securities and Exchange Commission (SEC) oversight of indexed annuities. This language is similar in intent to H.R. 2733/S. 1389. The conference report for H.R. 4173 was agreed to by the House on June 30, 2010, and by the Senate on July 15, 2010. President Obama signed the legislation into P.L. 111-203 on July 21, 2010.

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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 American International Group (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. Schapiro 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 with 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[8]

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. Consumer protection issues that relate to insurance products that are also considered securities would continue to be addressed by the Securities Exchange Commission (SEC).

Systemic Risk Provisions[9]

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 administered by the Federal Deposit Insurance Corporation (FDIC) rather than to standard bankruptcy provisions. H.R. 4173 makes it clear, however, that insurers are primarily to be resolved through the existing state resolution regime, primarily the insurance guaranty funds. Financial companies with assets exceeding $50 billion, including insurers, 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.

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[8] See CRS Report R40696, *Financial Regulatory Reform: Consumer Financial Protection Proposals*, by David H. Carpenter and Mark Jickling.

[9] See CRS Report R40877, *Financial Regulatory Reform: Systemic Risk and the Federal Reserve*, by Marc Labonte and CRS Report R40530, *Insolvency of Systemically Significant Financial Companies (SSFCs): Bankruptcy vs. Conservatorship/Receivership*, by David H. Carpenter.

Surplus Lines and Reinsurance[10]

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.

Senate Legislation (S. 3217)

In March 2010, 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 2010. This bill followed a similarly titled draft released in November 2009, which underwent substantial revision after its release. The committee amended and ordered Senator Dodd's bill favorably reported on March 22, 2010. It was reported on April 15, 2010, as S. 3217. It was subsequently brought to the Senate floor where, after numerous amendments, the Senate finished consideration on May 20, 2010. The Senate inserted the amended text of S. 3217 into the House-passed H.R. 4317 and passed this bill on a vote of 59-39. The text below discusses the amended version of S. 3217 as inserted into H.R. 4173.

Federal Insurance Office

The Office of National Insurance (ONI) proposed in S. 3217 is very similar to the concept originating in the 2008 Treasury Blueprint. It differs slightly from the Federal Insurance Office language as passed by the House. For example, the Senate bill ONI would have the power to issue subpoenas to gather information, whereas the House bill FIO would not. The House bill would also include a time period for congressional review of international agreements negotiated under the bill's authority, whereas the Senate bill would not.

[10] See CRS Report RS22506, *Surplus Lines Insurance: Background and Current Legislation*, by Baird Webel

Bureau of Consumer Financial Protection

The Bureau of Consumer Financial Protection under S. 3217 would be within the Federal Reserve rather than a separate agency and would differ in several other respects. As with the CFPA, however, consumer protections issues relating to the business of insurance would not fall under the oversight of the bureau, but, instead would remain within the purview of the states. Consumer protection issues that relate to insurance products that are also considered securities would continue to be addressed by the SEC.

Systemic Risk Provisions

S. 3217's systemic risk provisions are similar to the House provisions in terms of their impact on the insurance industry. Financial companies, including insurers, judged to be systemically significant by the Financial Stability Oversight Council would be subject to Federal Reserve oversight and higher prudential standards. Rather than requiring a state insurance regulator to be a member of the council, the Senate bill would mandate that a voting seat on the council be designated for a presidentially appointed member who is to be familiar with insurance issues. A financial company that owns one or more insurance companies could be subject to S. 3217's special resolution regime for systemically significant financial companies. However, as with the House bill, the insurance companies themselves would not be subject to this regime. Instead, the resolution of insurance companies would continue to be conducted in accordance with the applicable state insurance resolution system. With regard to funding for the resolution of systemically significant financial firms, there is no pre-funded resolution mechanism under S. 3217 as passed.[11] Instead, the FDIC would impose assessments on bank holding companies with more than $50 billion in assets, as well as other types of financial firms that are overseen by the Federal Reserve to fund the resolution of a systemically significant firm should the assets of the failed firm be insufficient to do so. The FDIC would impose such assessments on a risk-adjusted basis. When imposing such assessments on an insurance company, the FDIC is to take into account the insurers' contributions to a state insurance resolutions regime.

Surplus Lines and Reinsurance

S. 3217 includes essentially the same language as both H.R. 4173 and H.R. 2571/S. 1361, which would streamline the regulation and taxation of surplus lines and reinsurance.

The Dodd-Frank Wall Street Reform and Consumer Protection Act (P.L. 111-203)

The conference committee began meeting to reconcile the House and Senate bills on June 10, 2010, with a final conference report released on June 29, 2010. The House agreed to the conference report on June 30, 2010, by a vote of 237-192; the Senate agreed to the conference report on July 15, 2010, by a vote of 60-39. President Obama signed the legislation, now P.L. 111-203, on July 21, 2010.

[11] S. 3217 as reported included a pre-funded resolution mechanism, but this was removed during floor consideration.

Federal Insurance Office

The Dodd-Frank Act includes the creation of a Federal Insurance Office inside of the Department of the Treasury, blending the approaches of the House and Senate. For example, the conference report FIO would have subpoena power to collect data, as in the Senate bill, and includes the Senate's language on the standard required preempt state insurance measures.[12] The conference report language with regard to negotiation of international agreements, such as the requirement for congressional notification and layover largely follow the House approach. The act also requires *de novo* judicial consideration of preemption decisions under the Administrative Procedures Act as called for in the House version of H.R. 4173.

Bureau of Consumer Financial Protection

The Dodd-Frank Act creates a Bureau of Consumer Financial Protection within the Federal Reserve. This bureau enjoys significant budgetary independence and the director is to be appointed by the President and confirmed by the Senate. Consumer protections issues relating to the business of insurance, however, do not fall under the oversight of the bureau, but would remain within the purview of the states. Consumer protection issues that relate to insurance products that are also considered securities continue to be addressed by the SEC.

Investor Protection and Securities Provisions[13]

Although insurance products are generally under state regulation, there are some products, particularly variable annuities, which are considered securities products under federal law and jointly overseen by the SEC. In 2008, the SEC adopted new rules, generally known as "Rule 151A," that would have expanded SEC oversight to include some fixed indexed annuities that previously had solely been overseen by the states as insurance products. This rule has provoked controversy, with Representative Gregory Meeks and Senator Benjamin Nelson introducing the Fixed Indexed Annuities and Insurance Products Classification Act of 2009 (H.R. 2733/S. 1389) to overturn Rule 151A. H.R. 4173 included no provisions addressing Rule 151A as is moved through consideration in the House and neither did S. 3217 in the Senate; Senator Tom Harkin proposed S.Amdt. 3920, which would have added the text of H.R. 2733/S. 1389 to S. 3217, but the amendment was not considered on the floor of the Senate.

The conference committee agreed to an amendment by Senator Harkin, contained in Section 989J of the report, that did not insert the previous language specifically nullifying Rule 151A, but is broadly aimed at returning indexed annuities solely to state oversight. The exemption from SEC oversight in Section 989J depends in part on either the states or the companies meeting certain consumer protection standards. Depending on future regulatory action by the SEC, this exemption language may require court action before the full impact of Section 989J is known.

12 The House language would have required that the state insurance measure in question "directly" results in less favorable treatment of a non-U.S. insurer, while the Senate language does not include the term "directly."

13 See CRS Report RS22974, *Annuities and the Securities and Exchange Commission Rule 151A*, by Baird Webel

Systemic Risk Provisions

The Dodd-Frank Act provides for systemic risk provisions that impact the insurance industry primarily through oversight of firms deemed systemically significant and through specific financial resolution authority. Financial companies, including insurers, judged to be systemically significant by the Financial Stability Oversight Council are to be subject to Federal Reserve oversight and higher prudential standards. The council includes a presidentially appointed member who is to be familiar with insurance issues as a voting member and a nonvoting state insurance commissioner, to be selected in a process determined by the commissioners.

A financial company could be subject to the act's special resolution regime based on a finding that its failure would cause systemic risk. Any insurance subsidiaries of such a financial company, however, would not be subject to this regime. Instead, the resolution of insurance companies would continue to be conducted in accordance with the applicable state insurance resolution system. With regard to funding for the resolution of systemically significant financial firms, there is no pre-funded resolution mechanism under the act. Instead, the FDIC is to impose assessments on financial companies with more than $50 billion in assets, as well as other financial firms that are overseen by the Federal Reserve, to fund the resolution of a systemically significant firm should the assets of the failed firm be insufficient to do so. The FDIC is to impose such assessments on a risk-adjusted basis. When imposing such assessments on an insurance company, the FDIC is to take into account the insurers' contributions to a state insurance resolutions regime.

Surplus Lines and Reinsurance

The Dodd-Frank Act includes essentially the same language as H.R. 2571/S. 1361, which streamlines the regulation and taxation of surplus lines and reinsurance.

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