Reading Between the Lines of the Financial Services Reform Proposals: What Does it Mean for the Insurance Industry?

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On June 17, 2009, the U.S. Treasury Department released the Obama administration's broad overhaul of the federal financial regulatory system. Entitled "Financial Regulatory Reform, A New Foundation: Rebuilding Financial Supervision and Regulation", the 88 page report outlines reforms that, if adopted by Congress, will have far-reaching impacts upon the U.S. financial system, including new regulation of hedge funds, non-banking companies, over-the-counter derivatives, rating agencies, securitizations and consumer financial products and enhanced regulation of banks, investment banks and bank holding companies.

Despite its length, Treasury's report is short on specifics. While several new agencies are proposed and new powers are to be granted to existing agencies, including the Board of Governors of the Federal Reserve System and the Securities Exchange Commission, details have been left up to Congress and the administration to work out in the legislative process. A series of hearings has begun before the House Financial Services and Senate Banking Committees that will last into the fall, and some legislation has been introduced. There is much work to be done and open issues to be addressed before a complete detailed new scheme of financial services regulation can be implemented.

Most segments of the financial services industry can expect major changes in regulation and oversight even if only portions of the administration's plans are enacted. However, the report and subsequent public statements by Treasury Secretary Geithner, President Obama and their representatives offer little of substance with respect to the insurance and reinsurance industry. As a result, p&c, life and reinsurance industry leaders and trade groups have generally not taken issue with specific aspects of the reform proposal. Those on either side of the federal charter and state regulation of insurance debate have advocated that these matters be addressed in the reform proposal. Notably, the industry to this point has convinced the Treasury Department and some members of Congress that insurance products should not be regulated by the new Consumer Financial Protection Agency described below.

Significantly, the Report takes no position on federal charters for insurance companies and does not overtly propose changes to McCarran-Ferguson or the current state-based regulation of the insurance industry in the United States. But, as discussed below, the reform proposals grant to the Federal Reserve Board unfettered authority to regulate large insurance industry firms. Unfortunately, while for the first time a federal regulator could directly regulate insurance and reinsurance holding companies, the Administration has not offered a prescription for coordination of federal and state regulation of insurers and reinsurers.

The Treasury Department's reform proposal is intended to address, through more robust supervision, a number of factors that the Administration believes were the roots of the current financial crisis:

- insufficient risk management systems;
- lack of market transparency and standards;
- compensation systems that did not reward creation of long-term value;
- gaps and weaknesses in the supervision and regulation of financial firms that did not protect the economy and financial system as a whole.

Without offering any evidence or theoretical support, the report suggests that there is little doubt that these factors caused the financial meltdown and that the fix for the ills of the financial services industry are embodied in the reform proposal. Many commentators, regulators, legislators and industry participants have expressed broad support for the President's proposal. Notable among those expressing contrary views is Richard A. Posner who, writing at www.theatlantic.com on June 17, 2009, noted:

"throwing a raft of proposals at the banking industry while the industry is struggling to regain its footing, is sure to distract the banks' management, not to mention the Administration's economic team."

A central tenet of the reform proposal is the reordering of the federal regulatory system. A new body, the Financial Services Oversight Council, composed of the Secretary of the Treasury, Chairmen of the Federal Reserve Board, FDIC, SEC and the Commodity Futures Trading Commission, and the Directors of the new National Bank Supervisor, the new Consumer Financial Protection Agency, and the Federal Housing Finance Authority, will coordinate financial services regulation and oversight. Notably, since the proposal does not establish any separate federal insurance regulator, no representative to the Council will have a primary insurance or reinsurance regulatory focus. As discussed below, the Federal Reserve Board will regulate certain large insurance firms, but it will have many other responsibilities, including oversight of the banking industry and managing systemic risk within the financial service industry. The industry should ask itself whether there will be a federal regulator with sufficient interest in the insurance industry as a whole to effectively preserve and protect its future prospects.

A new Office of National Insurance within the Treasury Department will be established to gather information, coordinate policy and negotiate international agreements. However, this Office will have no regulatory authority over the insurance industry or policymaking authority. The Office will have no formal role within the Financial Services Oversight Council except the through the Secretary of the Treasury, who will chair the Council.

In addition to bank holding companies, the Federal Reserve Board will have authority over all financial services firms that could pose a threat to financial stability if they fail ("Tier 1 FHCs"). The Federal Reserve Board will determine what firms are Tier 1 FHCs. Thus, an insurance holding company, whose size, leverage and interconnectedness are deemed by the Federal Reserve Board to pose a sufficient threat to the financial system, will find its activities, capital and leverage subject to federal regulation, while it and its insurance subsidiaries also remain subject to state regulation. The Federal Reserve Board can require periodic reporting from all U.S. financial services firms meeting criteria to be established by the Federal Reserve Board to enable it to identify firms that may be Tier 1 FHCs. Accordingly, many insurance and reinsurance holding companies should expect to have federal reporting obligations, even if they are not classified as Tier 1 FHCs. Federal reporting requirements need not conform to or be consistent with current statutory or holding company reports to state regulators.

If the reform proposal is adopted as proposed, the Federal Reserve Board for all intents and purposes will be the new federal regulator of the insurance industry, or at least the larger participants in the industry, through its power to regulate Tier 1 FHCs.

Thus, it seems certain that if the President's proposals for broad oversight and supervision of the financial services industry are to apply to the insurance industry, the Federal Reserve Board may obtain by statute or court decisions the power to preempt state regulation of the insurance industry. Hopefully, Congress will take it upon itself to determine how overlapping state and federal authorities will be resolved with respect to large insurance and reinsurance companies, and their parent companies that are deemed to be Tier 1 FHCs, and that previously were not subject to federal regulation. If Congress does not address this conflict, inevitable tension between federal and state regulators will arise. Given past efforts by federal regulators to limit state regulation of banks, one can expect the Federal Reserve to seek clarification in court of any significant dispute with state insurance departments. This may mean a further erosion of the reservation of the regulation of insurance by the states but also could lead to uncertainty for the industry as to what regulatory master it serves. To avoid creating unfavorable decisions in federal court, state regulators may well shy away from confrontation with the Federal Reserve Board as to Tier 1 FHCs.

A new Consumer Financial Protection Agency would be created to establish standards and disclosures in connection with the sale of consumer financial services products. While the proposed reforms do not reference insurance products as included within this new Agency's authority, elsewhere in the proposals insurance companies are clearly considered to be financial services firms. As noted above, the industry for now is winning the argument that insurance products will not be subject to regulation by the new Agency.

The full impact of the reform proposals on the insurance and reinsurance industry will likely become clearer in coming months as Congress takes up the President's overhaul recommendations after hearings and testimony and discussion of enabling legislation. However, it seems clear that the industry will be regulated to some extent at the federal level and that the decades-old question of whether to repeal McCarran-Ferguson in whole or in part may be reconsidered again.

Perhaps of most concern to the industry is whether effective regulation and supervision of the industry is maintained at the state level or finally largely federalized. As some in the insurance industry have noted, the Office of National Insurance seems ill-suited to play the role of a federal insurance regulator, at least as currently constituted. Through its ability to regulate large insurance firms, there is a danger that through slow regulatory mission creep the Federal Reserve Board may gradually emasculate state regulators or create unequal playing fields between insurers controlled by Tier 1 FHCs and smaller firms. But since it will not have authority over all insurers it too cannot be a federal regulator of the entire industry.

The failure of the Administration's reform proposal to squarely address federal regulation of the insurance business creates significant challenges for the industry in planning for the future or seeking to influence the final form of the legislation. Reading between the lines of the proposal cannot provide much comfort to any insurance or reinsurance firm.