FINANCIAL REGULATORY REFORM: IMPLICATIONS FOR THE INSURANCE INDUSTRY

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To Our Clients and Friends:

Yesterday, President Obama announced the Administration's proposals for financial regulatory reform, and the Department of the Treasury released a comprehensive White Paper entitled "Financial Regulatory Reform: A New Foundation." As the title suggests, the White Paper is intended to lay the foundation for significant change in the way that financial firms, markets, products and services are regulated in the United States. Today, Secretary of the Treasury Timothy Geithner testified about the proposals before the Senate Banking Committee.

The White Paper sets forth five key objectives for financial regulatory reform that affect the insurance industry:

- Promoting robust supervision and regulation of financial firms.
- Protecting consumers and investors from financial abuse.
- Providing the government with the tools it needs to manage financial crises.
- Regulating over-the-counter derivatives, including credit default swaps.
- Raising international regulatory standards and improving international cooperation.

While the White Paper devotes only a small amount of text specifically to the insurance industry, the implications of the proposed reforms for the insurance industry generally are profound. Significantly, however, the White Paper mentions an optional federal charter for U.S. insurers but does not propose it as a component of financial regulatory reform. This client update outlines the key provisions that participants in the insurance industry will want to monitor closely as draft legislation is developed and moves through the federal legislative process.

SUPERVISION AND REGULATION OF FINANCIAL FIRMS

Insurers are within the scope of the proposed legislative reforms relating to supervision and regulation of financial firms. Key aspects of these proposed reforms include the following:

- Introduction of the concept of Tier 1 Financial Holding Companies ("Tier 1 FHCs"), which could include insurance holding companies and insurers (such as mutual life insurers). A Tier 1 FHC is defined in the White Paper as any financial firm whose combination of size, leverage and interconnectedness could pose a threat to financial stability if it failed, regardless of whether it owns an insured depository institution.
- Creation of a new Financial Services Oversight Council ("Council"), which would assist in identifying Tier 1 FHCs and setting material prudential standards for Tier 1 FHCs.
- Expansion of the role of the Federal Reserve as setter of prudential standards for Tier 1 FHCs, as final arbiter of what entities will qualify as Tier 1 FHCs and as regulator and supervisor of Tier 1 FHCs and of thrift holding companies that would become regulated as bank holding companies ("BHCs").
- Consolidating the supervision of federally chartered banking institutions in a new National Bank Supervisor and elimination of the federal thrift charter.
- Creation of a new Office of National Insurance in the Treasury.

The New Council. The formation of the Council and the regulation of Tier 1 FHCs are key elements of the White Paper's approach to the issue of systemic risk. The chair of the Council would be the Secretary of the Treasury. The Council would be made up of heads of the major federal financial services regulators. While the Council would not have any direct regulatory authority, it would have a broad mandate to facilitate information sharing and coordination among federal regulators, to provide a forum for discussion of cross-cutting financial regulatory issues and to identify and address regulatory gaps. The Council would have a permanent secretariat of expert staff in Treasury and have the authority to gather information designed to monitor emerging threats to financial stability. Information requests could be made of insurance holding companies and even insurers. The Council would prepare an annual report to Congress and would be charged with recommending firms that should be subject to Tier 1 FHC regulation. The Federal Reserve would be required to consult with the Council in setting material prudential standards for Tier 1 FHCs, and a subset of the Council would be responsible for determining whether to invoke new resolution authority with respect to large, inter-connected firms (*See* "Resolution Authority" below).

The Federal Reserve and its Expanded Role. Authority for the supervision and regulation of Tier 1 FHCs would be vested in the Federal Reserve. The Federal Reserve would be required to consult with Treasury in developing rules for identifying Tier 1 FHCs. Based on the White Paper, the guidelines would be quite broadly drafted. It appears that the Federal Reserve would be the final arbiter of what entities would qualify as Tier 1 FHCs.

The Federal Reserve would be authorized to collect periodic and other reports from and examine all U.S. financial firms (presumably including insurers and insurance holding companies) that meet certain minimum size thresholds. These reports and the scope of examinations are intended to be limited in the first instance to information needed to determine whether the subject firm is a Tier 1 FHC.

Tier 1 FHCs would be subject to stricter requirements than other financial firms regarding capital requirements, prompt corrective action, liquidity standards, standards for risk-management practices and enhanced public disclosures. In addition, Tier 1 FHCs would be required to comply with the non-financial activity restrictions of the Bank Holding Company Act ("BHC Act"). These would be new requirements for insurance holding companies that are Tier 1 FHCs but are not currently BHCs or FHCs, and such companies would have five years to conform their activities to those permitted by the BHC Act.

Tier 1 FHC supervision would extend to the parent company and all subsidiaries; however, functionally regulated subsidiaries, such as insurers, would continue to be supervised and regulated "primarily" by their functional regulator. The current deference to functional regulators in the BHC Act would be removed. The Federal Reserve would have authority to require reports and examine a Tier 1 FHC and all of its subsidiaries, including functionally regulated subsidiaries.

The Federal Reserve would have authority to impose and enforce prudential requirements on a regulated subsidiary of a Tier 1 FHC – for example, an insurer subsidiary – that are more stringent than those imposed by the subsidiary's primary regulator to address systemic risk concerns, but only after consulting with the subsidiary's primary regulator and Treasury. A Tier 1 FHC would have to report regularly on the nature and extent to which other major firms are exposed to it, *e.g.*, counterparties that would suffer loss if the Tier 1 FHC failed.

Under the White Paper, Treasury is to lead a working group to conduct a fundamental assessment of existing capital requirements for banks and BHCs, including new Tier 1 FHCs. The report is to be due by December 31, 2009. Among the matters to be considered by the working group are: (1) proposed increases in regulatory capital for such investments as equity investments, highly rated ABS and MBS investments and OTC derivatives that are not centrally cleared, and (2) the importance of a simpler, more transparent leverage measure. As a result, insurance holding companies that are BHCs or Tier 1 FHCs may be subject to increases in regulatory capital requirements.

All Thrift Holding Companies to Become BHCs. Under the White Paper, the Office of Thrift Supervision would be eliminated. Thrift holding companies would become BHCs supervised by the Federal Reserve and not the Office of Thrift Supervision (or its successor the new National Bank Supervisor). BHCs (including thrift holding companies that would become BHCs) that own insurers would presumably need to qualify as financial holding companies ("FHCs"). Since BHCs and FHCs are subject to restrictions on non-financial activities, new BHCs and FHCs would have five years to conform their activities to the activity restrictions of the BHC Act or presumably divest their depository subsidiaries.

The New National Bank Supervisor. A new National Bank Supervisor would supervise and regulate all federally chartered depository institutions, including federal thrifts. The National Bank Supervisor would take over the role of the Office of the Comptroller of the Currency for national banks and the Office of Thrift Supervision for federal thrifts. Under the White Paper, the federal thrift charter would be eliminated. Those insurance holding companies that own thrifts would have a new regulator, the National Bank Supervisor, with respect to their federal thrift, and a new regulator, the Federal Reserve, at the holding company level.

New Office of National Insurance. An office in the Department of the Treasury is to be established called the "Office of National Insurance" ("ONI"). Among the functions of the ONI would be the following: (1) monitor all aspects of the insurance industry; (2) gather information and identify the emergence of any problems or gaps in regulation that could contribute to a future crisis; (3) recommend to the Federal Reserve any insurers that the ONI believes should be supervised as Tier 1 FHCs; and (4) assume Treasury's responsibilities under the Terrorism Risk Insurance Act. In addition, the ONI would be authorized to work with other nations and the International Association of Insurance Supervisors to better represent American interests and have authority to enter into international agreements and increase cooperation on insurance regulation.

The Council would not specifically include a representative of the ONI but it would be chaired by the Secretary of the Treasury, in whose department the ONI would be located. Furthermore, the ONI would not have a direct role in identifying insurers that are Tier 1 FHCs – it would make recommendations on this subject to the Federal Reserve which would make that decision. Lastly, if a failing firm includes an insurer, the ONI would not have a direct role, but would provide consultation to the Federal Reserve and FDIC boards on insurance specific matters (*See* "Resolution Authority" below).

This proposal is not new. It was mentioned in the Treasury's March 2008 "Blueprint for a Modernized Financial Regulatory Structure" and was the subject of two House bills, H.R. 5840, introduced in early 2008, and H.R. 2609, introduced in May 2009.

CONSUMER PROTECTION

Consumer protection is addressed in the White Paper through the creation of a new federal agency, the Consumer Financial Protection Agency ("CFPA"). This is a kind of financial product analog to the Consumer Product Safety Commission. Legislation addressing this same idea to create a "Financial Product Safety Commission" was introduced in the House and the Senate in early 2009 – H.R. 1705 and S. 566.

The CFPA would be dedicated to protecting consumers in the financial products and services markets – investment products and services already regulated by the Securities and Exchange Commission ("SEC") or Commodity Futures Trading Commission would be excluded. This suggests that, for life insurers, the CFPA would not have jurisdiction over retail variable universal life and variable annuity contracts.

The CFPA would have jurisdiction over "consumer financial services and products such as credit, savings and payment products and related services." The CFPA would, by regulation, be able to set minimum national standards for these products and states would be allowed to set standards higher than the minimum federal standards. The CFPA is to be funded by fees assessed on entities that offer covered products and services and covered transactions.

Whether products or services over which the CFPA has jurisdiction might include insurance contracts is not clear. On one hand, insurance contracts are neither expressly included nor expressly excluded in the White Paper – they are simply not mentioned. On the other hand, a June 14, 2009, *Washington Post* op-ed page article by Messers. Geithner and Summers on financial regulatory reform mentions annuities as a kind of financial product that had inadequate consumer protections that need to be remedied. So we will have to wait for the actual proposed legislation creating the CFPA to determine whether the agency would have any jurisdiction over insurance contracts and, if so, what kinds of insurance contracts.

RESOLUTION AUTHORITY

The White Paper recommends that a new resolution authority for BHCs and Tier 1 FHCs be enacted. This resolution authority would be modeled after the Federal Deposit Insurance Corporation ("FDIC") resolution authority for insured depository institutions and would allow the resolution of failing BHCs and Tier 1 FHCs where the stability of the financial system is at risk. Insurance holding companies that are BHCs or Tier 1 FHCs could be subject to this new resolution authority. A detailed legislative draft of this proposal was released by Treasury on March 25, 2009. The White Paper builds on the previous proposal by clarifying which firms may be subject to the resolution authority and who decides to invoke the resolution authority.

The White Paper states that the new authority would be only for extraordinary times and would be subject to strict governance and control procedures. The use of this resolution authority could be initiated by Treasury or the Federal Reserve, but the FDIC could also initiate its use (or the SEC could also initiate its use when the largest subsidiary of the failing firm is a broker-dealer or securities firm).

Procedurally, Treasury could invoke the resolution authority after consulting with the President and on recommendation of two-thirds of the members of each of the Federal Reserve and FDIC boards. If the largest subsidiary of the failing firm is a broker-dealer, a two-thirds vote of the SEC Commissioners would take the place of the FDIC board vote. If the failing firm includes an insurer, the ONI would provide consultation to the Federal Reserve and FDIC boards on insurance specific matters.

Treasury would decide how to resolve the failing firm. This could include providing loans, guarantees or equity to the firm or establishing a conservatorship or receivership. Treasury would appoint the FDIC as conservator or receiver (or the SEC, where the largest subsidiary is a broker-dealer) if it decides to establish a conservatorship or receivership. The receiver or conservator would be authorized to borrow from Treasury when necessary and Treasury would be authorized to issue public debt to finance such loans. Any such loans would be repaid by assessments on BHCs. Although the White Paper does not include Tier 1 FHCs as being subject to assessments, we believe this was merely a drafting oversight. Assessments would be based on total liabilities (other than liabilities that are assessed to fund other federal and state insurance schemes).

REGULATION OF OVER-THE-COUNTER DERIVATIVES

The White Paper, as part of its proposals for comprehensive regulation of financial markets, includes a recommendation that all OTC derivatives markets, including the market for credit default swaps, should be subject to comprehensive regulation. The new regulatory regime would mandate amendments to the Commodities Exchange Act and the federal securities laws that would require all "standardized" OTC derivatives to be traded through regulated central counterparties ("CCPs"). CCPs would be required to impose margin requirements and other risk controls, and there would be a requirement that customized (*i.e.*, non-standardized) derivatives not be used solely as a means to avoid trading through a CCP. The White Paper states that all firms whose activities in the OTC derivatives market create large exposures to counterparties should be subject to a robust and appropriate regime of prudential supervision that includes conservative capital requirements. There is also a strong push in the direction of greater market efficiency and transparency. Insurers, and in particular life insurers, are large participants in the OTC derivatives markets, predominantly to hedge their investments and other exposures. While the regulatory proposals set forth in the White Paper are not explicitly directed at insurers, the additional capital requirements, reporting obligations and other restrictions on this market will likely lead to some modifications in the manner in which life insurers conduct their hedging activities.

INTERNATIONAL STANDARDS AND COOPERATION

While the White Paper includes many recommendations to raise international regulatory standards and improve international cooperation, the only insurance specific proposal is the one contained in the proposal to establish the ONI. While states, state insurance regulators and the National Association of Insurance Commissioners cannot negotiate treaties with other nations, the federal government, through the ONI, could. The White Paper proposes that the ONI be authorized to work with other nations and have authority to enter into international agreements and increase cooperation on insurance regulation.

SUMMARY

In summary, insurance holding companies and insurers may be subject to the following increased burdens if the White Paper recommendations are implemented:

- Those whose failure would pose a threat to financial stability would become Tier 1 FHCs subject to direct regulation and supervision by the Federal Reserve. Both the Tier 1 FHC holding company and its operating companies would be subject to regular reporting to and examination by the Federal Reserve. Furthermore, an operating company may be subject to more stringent prudential standards imposed by the Federal Reserve than by its primary regulator. Insurance holding companies and insurers that are identified as Tier 1 FHCs would be subject to restrictions on non-financial activities (with five years to conform).

- Both the holding company and operating companies that meet certain size thresholds would be subject to reporting to and examination by the Federal Reserve to help the Federal Reserve determine whether they would be designated Tier 1 FHCs.

- Insurance holding companies and insurers would be subject to information requests from the Council for purposes of monitoring emerging threats that activities in financial markets may pose to financial stability.

- Insurance holding companies and insurers would be subject to information requests from the ONI.

- Insurance holding companies that own thrifts would become BHCs (and FHCs) and be subject to restrictions on non-financial activities (with five years to conform in the case of new BHCs and FHCs).
- If insurance contracts come within the scope of the products and services subject to regulation by the CFPA, then insurers would have an additional market conduct regulator, the CFPA.
- U.S. insurance regulation could change depending on the outcome of any treaty negotiations concluded by the ONI. One area of interest to some international reinsurers will be collateral requirements imposed by state law on reinsurance ceded to unauthorized reinsurers.

We will be watching as the White Paper develops into actual legislative proposals.

If you would like more information on these or other topics of interest, please contact the undersigned or any insurance industry lawyer at Debevoise & Plimpton LLP.

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