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The Consumer Financial Protection Agency: For Better or Worse, a Work in Progress

by Satish M. Kini and Thomas S. Wyler

On October 22, the House Financial Services Committee (the "Committee") approved H.R. 3126, the Consumer Financial Protection Agency Act of 2009 (the "CFPA Act"), by a vote of 39 to 29. The House Committee on Energy and Commerce will take up the bill next, after which it will be considered by the full House. The Senate has not begun to consider this legislation, although it has been reported that Senator Shelby, the ranking Republican on the Senate Banking Committee, is opposed to the Consumer Financial Protection Agency (the "CFPA")

The CFPA Act has been among the most hotly debated aspects of the Obama Administration's proposals to reform the financial services regulatory structure. The bill, as originally proposed by the Administration and now as reported out of the Committee, would create the CFPA to regulate a host of financial institutions that provide consumers with financial products and services, including credit cards, mortgages, and other loan and depository products. The version of the bill reported out of Committee includes a number of amendments and changes to the Administration's proposal, many of which represent attempts to respond to concerns expressed by clashing interest groups with different views of the need for and the value of this legislation.

This article highlights three key areas of debate involving the CFPA Act and the compromises fashioned on these controversial points. All three areas are likely to remain hotly contested as the CFPA Act continues to wind its way through the Congress.

Businesses Covered by the CFPA

Since the Administration originally proposed the CFPA, a key issue has been which businesses would be subject to the new agency's regulatory authority. Many industry participants – and, in classic Washington-style, their regulators – have been keenly interested in remaining outside the CFPA's jurisdictional reach; many consumer groups have been concerned that the legislation will be riddled with carve-outs and special exemptions. The Committee bill clarifies and, in some situations, expands the categories of entities and activities that would fall outside the CFPA's authority.

Insurance Companies. The Committee's bill expressly excludes from the jurisdiction of the CFPA those persons "engaged in the business of insurance" and "subject to regulation by any State insurance regulator," but only to the extent that such persons act in "such capacity." The Committee's bill reserves to state insurance regulators the power to adopt rules and initiate

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enforcement proceedings with respect to companies that they regulate.

The CFPA generally would "have no authority" to exercise power against these excluded persons. That said, the CFPA would retain the power to exercise authority against these excluded persons to the extent that they engage in other activities defined as "financial activities" under the CFPA Act, such as extending consumer credit.

Investment Advisers. The Administration's bill had excluded from the CFPA's authority investment advisers registered with the Securities and Exchange Commission (the "SEC") or the Commodities Futures Trading Commission (the "CFTC"). The Committee's bill extends the exemption to cover any investment adviser regulated by any state securities commission.

SEC- and CFTC-Regulated Entities. The Administration's bill generally had excluded from the jurisdiction of the CFPA those entities regulated by the SEC and CFTC. The Committee's bill clarifies that those exclusions apply to, among others, municipal

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Letter from the Editor

During the last month, U.S. legislators and regulators have shown renewed focus in their effort to enact significant regulatory reforms in the wake of the financial crisis. As we reported in the October issue of the Financial Institutions Report, in September President Obama reaffirmed the administration's ongoing commitment to reform. Congressional committees had been working through the summer, and now we are seeing a flurry of activity.

On October 22, the House Financial Services Committee voted to advance legislation that would create a new Consumer Financial Protection Agency with broad powers to regulate financial products and services. Our first article in this issue describes key features of this legislation, as well as provisions that are likely to serve as focal points for continuing debate among legislators, regulators and other interested parties.

The House Financial Services Committee has been active on other fronts as well. Last week, the Committee released a discussion draft of financial regulatory reform legislation that would give the federal government new powers to unwind systemically important financial institutions in the event of failure. This legislation includes other important features, including a new council of regulators to monitor systemic risks, that are drawn in part from comprehensive reform proposals advanced by the U.S. Treasury earlier this year. The Committee's discussion draft was the topic of widely reported hearings last week, and will likely be the subject of continued debate through the fall. We will plan to report on the legislation's progress during the coming months.

In this issue, we also present articles on two topics of particular interest in the insurance industry. First, Stuart Hammer and Ben Lesnak describe several initiatives that may result in increased public disclosure by insurance companies of the risks associated with climate change. Second, Christopher Henley of our London office analyzes significant recent developments in U.K. case law relating to reinsurance.

Developments in the world of financial institutions continue at a furious pace, and we hope that these articles prove useful to you. We will continue to participate in these developments, and look forward to reporting on them in future issues of the Debevoise & Plimpton Financial Institutions Report and in Client Updates.

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Insurance Companies Confront Climate Change Disclosure Obligations

by Stuart Hammer and Ben Lesnak

Various disclosure initiatives are forcing insurance companies to assess how to disclose their climate change risks. The risk of insurance claims related to hurricanes, floods, wildfires and other natural catastrophes linked to climate change threatens the long-term profitability of some insurers, particularly property and casualty insurers. At the same time, investments held by insurance companies, including life insurers, may be at risk due to climate change and climate change legislation.

Underwriting Risks. A July 2009 report issued by the International Association for the Study of Insurance Economics (more commonly known as The Geneva Association), a group composed of chief executive officers from some of the largest insurance companies, concluded that climate change is the insurance industry's number one long-term priority. According to the report, extreme weather events caused by global climate change have resulted, and will continue to result, in an increase in property and casualty insurance claims.

Climate change is believed to have contributed to the devastation caused by, and losses resulting from, recent extreme weather and catastrophic events. Many scientists believe warming sea temperatures have increased the intensity of hurricanes, which, when combined with rising sea levels, have increased damages caused by flooding, such as the damage caused in Hurricane Katrina. Similarly, higher temperatures and drier conditions have increased the risk of, and damages caused by, forest fires, such as the damage caused in recent California wildfires. The report also noted that extreme weather and catastrophic events have increased over the last several years, resulting in billions of dollars in insurance claims.

Recent reports suggest that losses from climate change-related disasters will increase. A June 2009 report from the U.S. Global Change Research Program, an organization composed of various government agencies, noted that significant damage is expected to result from rising sea levels, jeopardizing coastal properties and infrastructure. Additionally, changes in precipitation patterns will likely increase flooding in certain regions, while causing severe droughts in others. Extreme weather events may disrupt business operations in the energy, transportation, agriculture and other sectors.

Liability insurance companies may see an increase in claims as climate change-related lawsuits are filed against oil, coal and power companies and other large emitters of greenhouse gases. A May 2009 Swiss Re report warned of the proliferation of climate change lawsuits in the United States. Similarly, in a September 2009 report, the CEA, the European insurance and reinsurance federation, recognized increased underwriting risks due to climate change.

In addition, two recent United States Court of Appeals cases are making it easier for plaintiffs to pursue climate change-related lawsuits against emitters of greenhouse gases. In Comer v. Murphy Oil Co., the U.S. Court of Appeals for the Fifth Circuit ruled that a group of Mississippi property owners that suffered losses in Hurricane Katrina could proceed with a suit against several oil and chemical companies whose greenhouse gas emissions allegedly contributed to plaintiffs' damages. Similarly, in Connecticut v. American Electric Power Co., the U.S. Court of Appeals for the Second Circuit allowed several states and land trusts to proceed with a suit against power companies whose carbon dioxide emissions were alleged to constitute a nuisance under federal law.

Investment Risks. Insurance companies' investments may be at risk due to climate change concerns. Investments in real estate, particularly properties located in coastal areas, could be affected by more hurricanes, flooding, rising sea levels and other severe weather events. Even the value of municipal bonds, a traditional investment for many insurers, may be at risk as municipalities incur costs to adapt to climate change-related issues.

In addition, investments in carbon-intensive industries and businesses that may be ill-prepared to address the effects of climate change legislation or regulations could be compromised. The climate change bill that passed the U.S. House of Representatives in June 2009, the American Clean Energy and Security Act, and a similar bill that is currently being considered by the U.S. Senate, will, if passed, affect the operations, earnings and liquidity of various industrial companies. Investments in those companies could be diminished. Similarly, the United States Environmental Protection Agency has proposed rules for regulating greenhouse gas emissions, which rules could have a significant impact on large greenhouse gas emitters.

Climate Risk Disclosures. Insurance companies' disclosure of climate change risks have generally taken place, or will take

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place, within the framework of a recent National Association of Insurance Commissioners (the "NAIC") initiative, through voluntary disclosure under the Carbon Disclosure Project or pursuant to disclosure requirements of the Securities and Exchange Commission (the "SEC").

1. *NAIC Disclosure*. In March 2009, the NAIC adopted the Insurer Climate Risk Disclosure Survey (the "Disclosure Survey") containing mandatory annual climate change disclosure requirements for insurers. Beginning May 1, 2010, all property, casualty, life and health insurance companies with more than $500 million in annual premiums will submit a Disclosure Survey to the department of insurance in the state in which their company reports the largest volume of premiums annually. Beginning May 1, 2011, those reporting obligations will be expanded to insurance companies with annual premiums in excess of $300 million.

The Disclosure Survey provides insurance regulators, investors and consumers with information concerning an insurer's climate change liabilities and obligations. The Disclosure Survey requests information about the following: (1) the company's plans to reduce its own greenhouse gas emissions; (2) climate change policies or procedures used by the company in its risk and investment management; (3) the company's procedures used to identify climate change-related risks; (4) the current or anticipated implications (including financial implications) of identified climate change risks; (5) whether the company has considered the impact of climate change on its investment portfolio and if such consideration has resulted in any investment strategy changes; (6) whether the company has encouraged policyholders to mitigate potential climate change-related losses; (7) whether the company has engaged key constituencies regarding climate change; and (8) steps the company is taking to manage climate change risks with respect to the company's business.

The Disclosure Survey does not require insurance companies to disclose information that is immaterial, quantitative, commercially sensitive or forward-looking, though a company may voluntarily provide forward-looking information and disclaim responsibility for the accuracy of such information.

Despite the tepid response of some insurance industry groups towards the Disclosure Survey, several insurance companies have agreed to voluntarily respond to the survey as part of a pilot program. Voluntary responses from several insurers were presented at the NAIC's 2009 Fall National Meeting. Most of the responding companies lacked a specific policy addressing climate change or identifying climate change-related risks. Instead, the insurers addressed climate change risks through their existing internal avenues of risk assessment and relied on their investment managers and credit rating agencies to monitor the impact of climate change and proposed climate change legislation.

Because the NAIC lacks the authority to require insurers to complete and submit the Disclosure Survey, individual state insurance regulators may choose whether or not to require the survey. It is unclear how many states will require their domestic insurance companies to submit the Disclosure Survey.

2. *Carbon Disclosure Project*. The NAIC's Disclosure Survey builds upon the existing Carbon Disclosure Project (the "CDP") survey. Founded in 2000, the CDP is a not-for-profit organization which compiles the world's largest database on public company information relating to climate change. Each year, the CDP requests that public companies voluntarily respond to climate change-related questions. The CDP's questions are substantially similar to the questions in the NAIC's Disclosure Survey.

According to an April 2009 report from Ceres, a coalition of investors, environmental groups and public interest organizations working with companies to address sustainability issues, 69% of U.S. insurance companies provided responses to the CDP survey in 2008. The report noted that the responses of U.S. insurance companies tended to be less descriptive than those of European insurance companies. According to the report, U.S. insurers were also more likely to request their responses not be made public.

3. *SEC Reporting Requirements*. U.S. securities laws require publicly-traded companies to disclose material environmental risks. While the SEC does not specifically require climate risk disclosure, SEC rules generally require companies to disclose any material effect resulting from compliance with laws, any material litigation and any known trends or uncertainties likely to affect a company's bottom line.

A June 2009 report from Ceres and the Environmental Defense Fund shed light on climate disclosure by insurance companies. The report surveyed the 2008 Form 10-K disclosures of insurance holding companies. Only nine of 27 insurance holding companies identified climate change issues in their disclosures. Of the nine, only three mentioned any substantive actions they had taken to address climate change. The report noted that the insurance industry disclosed the fewest climate change-related material risks of any industry surveyed.

Pressure has been building on the SEC to address climate change disclosure. Institutional investors, environmental organizations and others have argued that climate change may result in material risks

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warranting disclosure by certain companies. In June 2009, members of the Investor Network on Climate Risk (the "INCR") and other leading investors sent a letter to the SEC requesting that it address disclosure of climate change risks. Signatories to the letter included some of the largest public pension funds, asset managers, foundations and other institutional investors with approximately $4.1 trillion in assets under management. They asked the SEC to, among other things, issue formal guidance on material climate-related risks that companies should disclose and to enforce existing disclosure requirements. The INCR letter followed 2007 and 2008 petitions to the SEC for which the SEC has yet to respond.

However, the SEC may soon clarify the climate disclosure requirements. In July 2009, SEC Commissioner Elisse Walter stated that the SEC was taking a very serious look at climate change disclosure. Commissioner Walter and other SEC officials have held meetings with climate change disclosure advocates to discuss disclosure requirements. Commissioner Walter recently said she believed the SEC should consider issuing interpretive guidance regarding environmental disclosure.

Conclusion. Though they are not large emitters of greenhouse gases, insurance companies are bearing witness to the effects of global climate change. As insurance companies assess climate change-related risks, they will need to reevaluate their disclosure obligations. Over the next several months, states may determine whether to require insurers to complete the NAIC Disclosure Survey, the SEC may clarify climate risk disclosure obligations and the United States Senate may pass comprehensive climate change legislation affecting emitters of greenhouse gases. Insurance companies will need to monitor these and other developments and assess their obligations to disclose their climate change risks. ■

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U.K. Legal Developments in "Back-to-Back" Reinsurance Coverage

by Christopher Henley

In *Lexington Insurance Company v. WASA International Insurance Company*[1], a case of fundamental importance to the reinsurance market, and particularly non-UK insurers reinsuring into London, the House of Lords has ruled on the efficacy of back-to-back provisions and the impact of clauses in the underlying insurance on the related reinsurance.

The dispute arose out of the facultative proportional reinsurance by the reinsured, Lexington, of the environmental clean-up costs incurred by its insured, Alcoa. In the early 1990s Alcoa had been ordered by the U.S. Environmental Protection Agency to clean up pollution at several manufacturing sites in respect of pollution that had occurred between 1942 and 1986. Alcoa sought to recover its inwards claims and costs from Lexington. Lexington's insurance of Alcoa ran for a 3 year period from 1 July 1977 to 1 July 1980. The underlying insurance contract contained no governing law clause, but included a "service of suit" clause providing that Lexington would submit, at Alcoa's request, to the jurisdiction of any court in the United States for the resolution of any dispute. The ensuing dispute reached the Washington State Supreme Court, which applied Pennsylvania law to the underlying policy and instead of prorating the amount due by Lexington, held that Lexington was jointly and severally liable for the whole of Alcoa's clean-up costs[2], despite the fact that Lexington had only been at risk for 3 of the 44 years during which the pollution had occurred. Lexington then settled Alcoa's claims in a deal spanning all 44 years of the remedial costs before claiming against its reinsurers. It was significant that the underlying argument was not about the date on which the damage occurred; Lexington's settlement was predicated on the basis that it was liable for the costs of remedying the damage which occurred outside its period of cover owing to the absence of an exclusion for loss that had started prior to that cover. Although 97.5%

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of the reinsurers paid Lexington, WASA then applied to the Commercial Court in London for a declaration that it was not obliged to follow Lexington's settlement because the loss did not fall within the scope of the reinsurance contract as a result of its express period clause, which clearly imposed a temporal limit on the cover. The reinsurance contract (which the parties agreed was subject to English law) contained full reinsurance and follow the settlements clauses[3], the words "as original", and covered the identical period and same subject matter as the underlying insurance. It was also agreed that in settling the claim, Lexington had acted in a bona fide manner.

When the case came before the Commercial Court in 2007, the court held that although the contracts were intended to be back-to-back, reinsurance contracts were distinct and independent contracts and terms within the reinsurance should not be distorted or disregarded to make them more consistent with the original cover. It held that the reinsurers had clearly only agreed to reinsure the insurer "during the continuance of the policy", i.e., for the relevant 3 year period as defined in the reinsurance policy.

The Court of Appeal overturned the decision of the Commercial Court and held the reinsurer liable. The Court of Appeal considered that the key issue to determine was whether the parties intended, to the extent that they used the same or equivalent wordings in the reinsurance as the underlying insurance, that the wording would have the same meaning in both contracts. The court held that the general principle in such circumstances is that the same or equivalent wording in each of the contracts should be given the same construction, unless there are clear indications to the contrary. The fact that law in the U.S. had not reached the point where an insurer on risk for a limited period could be liable for any point outside that period was negated by the fact that the insurer or reinsurer assumed the risk of any change in the law.

This decision clearly has the capacity to create considerable uncertainty, although it could be regarded as an unusual case.

After the ruling of the Court of Appeal, the matter proceeded to the House of Lords, who have recently confirmed that the period of cover in any policy is of fundamental importance, and that the reinsurers had clearly only agreed to reinsure Lexington, and had rated the reinsurance for premium, only "during the continuance of the policy", i.e., for the relevant 3 year period as defined in the reinsurance policy. The 40 year period of cover did not therefore appear to fall within the reinsurance as a matter of law, but the reinsured argued that the presumption of back-to-back cover enabled it to succeed on the basis that the parties intended the relevant provision in the reinsurance to have the same meaning and effect as the underlying contract. Thus despite thinking that it had contracted to provide three years' cover, the reinsurer would on this basis be dragged into a 40 year liability.

English case law presumes that facultative proportional reinsurance is on a back-to-back basis with the underlying coverage so that a claim properly paid in accordance with the underlying insurance would be indemnified by the reinsurance. However, in this case the contracts were not entirely back-to-back because they were ultimately governed by different applicable laws. The back-to-back presumption was rebutted primarily because it was not possible at the time of placement of the reinsurances to ascertain the construction that the applicable law of the underlying insurances would place on the underlying policy. In the words of the House, "[t]he reinsurance has a clear English law meaning. There was here no identifiable legal dictionary (formal or informal), still less a Pennsylvanian legal dictionary, which can to be derived from the interaction or operation of the terms of the insurance and reinsurance and which could lead to any different interpretation of the reinsurance wording." The House considered that Massachusetts law would have been applied by an English court and took account of the fact that the Washington State Supreme Court had applied Pennsylvania law as a matter of case management, being the common denominator in multilayered policies spanning several US states and 44 years, thereby taking into account matters and events extraneous to the reinsurance policy in question.

It was certainly accepted that a different construction would be placed on the underlying insurance in different U.S. jurisdictions, and therefore there was no way of predicting the construction that would be placed on the period clause at the time the reinsurance was placed because it was not clear that either the Washington State Courts would deal with the claim or that any court would apply Pennsylvania law. It is on any view correct that equivalent terms in two contracts should not be given the same legal definition if the parties could not have had in mind a legal definition taken from the relevant case law of the local system of law when forming the contract, or a "private

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dictionary" exception, i.e., a common definition agreed by the parties themselves. The duration of the policy was also a matter of fundamental importance and would not be amended solely because of the back-to-back nature of the reinsurance.

Their Lordships also held that although reinsurance is in effect an insurance of the insurer's liability, legally its subject matter is the subject matter of the original insurance. So where does that leave non-UK insurers whose reinsurances into London are subject to English law? This decision clearly has the capacity to create considerable uncertainty, although it could be regarded as an unusual case. There are two obvious solutions. The first is to ensure that both contracts are governed by the same law, a prospect unlikely to endear itself to English underwriters. The second is to convert the reinsurance into a liability policy, which in theory could be effected as a matter of contract – although the contractual pointers towards a fully back-to-back arrangement could hardly have been stronger than in this case. Some careful drafting will be required. ■

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[1] [2009] UKHL 40.

[2] Relying upon JH France Refractories Co. v. Allstate Insurance Co., 534 Pa. 29, 626 A.2d 502 (1993).

[3] The relevant clauses in the contract stated: "[b]eing a reinsurance of and warranted same gross rate, terms and conditions as and to follow the settlements of the [reinsured] …"

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securities dealers, self-regulatory organizations and other similar entities registered with the SEC and introduces brokers, boards of trade and derivatives clearing organizations registered with the CFTC.

Retailers and Auto Dealers. Under the Committee's bill, retailers that provide store credit generally are outside the CFPA's purview. Similarly, auto dealers, including those that provide vehicle financing, generally are excluded from the CFPA's rulemaking and jurisdiction.

Service Providers. The Administration's bill had placed within the CFPA's purview those engaged directly or indirectly in the provision of consumer financial products or services and those who "provide a material service to, or process . . . a transaction on behalf of," such purveyors of consumer financial products.

The Committee bill also includes "service providers" within the CFPA's jurisdiction. Service providers are defined as those providing a "material service" to a provider of consumer financial products or services, including those that: (a) facilitate the design of a consumer financial product or service, (b) have direct interaction with a consumer regarding a consumer financial product or service, or (c) process transactions relating to a consumer financial product or service.

The term "service provider" excludes those that provide "a support service of a type provided to businesses generally." Also excluded are those that provide services that do not "materially affect the terms or conditions of a consumer financial product or service," and those that help advertise consumer financial products or services.

These definitions remain, in many respects, vague. The result may be further controversy and, if the CFPA Act is enacted in current form, litigation.

Preemption

Another area of particular controversy has been the allocation of rulemaking and other authority between the CFPA and the states. Many consumer advocates, and some state regulators, have argued that state laws aimed at protecting state residents from predatory practices should not be preempted by federal standards. They argue that widely publicized recent abuses were the result of such preemptive actions on the part of federal banking regulators. Banking industry groups counter that, in the absence of strong federal preemption, banking institutions could be subject to a complicated quilt of state regulatory regimes, which will make operating interstate businesses cost prohibitive.

The Administration bill had, essentially, crafted the CFPA Act to establish a regulatory floor and had allowed states to "exceed or supplement" the CFPA's requirements and to apply such higher

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standards to national banks and federal thrifts. The Committee bill attempts a more finely tuned compromise.

Under the Committee bill, national banks and federal thrifts "shall generally comply" with state laws. A state law's application to national banks and thrifts is preempted only if (1) the state law discriminates against nationally chartered depository institutions, (2) the Office of the Comptroller of the Currency (the "OCC") or Office of Thrift Supervision (the "OTS") formally determines that a state law "prevents or significantly interferes" with the ability of a national bank or federal thrift to engage in its business, or (3) the state law is preempted by some other federal law (and not the CFPA Act).

To exercise their preemption powers, the OCC and OTS must undertake various procedural steps. For example, the agencies must have "substantial evidence" and make "specific findings" before determining that a federal regulation preempts a state consumer financial law. In addition, the agencies need to review their preemption determinations on a periodic basis.

The courts are permitted to review the OCC and OTS's preemption decisions without deference to the federal agencies. To this end, the CFPA Act expressly "does not occupy the field in any area of State law."

These provisions are likely to remain highly controversial, and are unlikely to please national banks, thrifts or the federal banking regulatory agencies. If enacted as currently drafted, these provisions may lessen the value of a national depository institution charter and the regulatory certainty that accompanies federal preemption. The state charter, which often requires less capital and is less heavily regulated, may become more popular. The result may hinder interstate banking and lending activities.

Another key issue has been the scope of the CFPA's examination authority and whether that agency, or other regulatory authorities, would examine financial institutions for compliance with the CFPA Act. Many banks and thrifts, in particular, had sought to ensure that they would not be subject to a new examination authority.

The state charter, which often requires less capital and is less heavily regulated, may become more popular.

The Committee's bill would exempt insured depository institutions with assets under management of less than $10 billion and credit unions with assets of under $1.5 billion from examination by the CFPA. These exempted institutions would remain fully subject to the rules of the CFPA, but they would continue to be examined by their prudential regulators. The CFPA would retain the authority to send examiners to participate in the prudential regulators' exams, to require that all examination information and data be forwarded to the CFPA, and to remove a prudential regulator on a case-by-case basis if the CFPA determines that the regulator did not adequately fulfill its supervisory responsibilities.

* * *

It remains to be seen how these key issues will be resolved both in Congress and, if the CFPA Act is enacted, in the marketplace. As noted above, the House Committee on Energy and Commerce, which has jurisdiction over some of the issues addressed in the CFPA Act, will next consider the legislation. A robust debate undoubtedly will continue when the bill reaches the floor of the House. With respect to the Senate, which has generally been moving more slowly on financial regulatory reform, the legislation has yet to be considered, and its prospects there are uncertain. The three key issues noted above are likely to be among the topics most hotly debated as the fight continues. ■

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