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29 - Federal Overview

Developments in the Regulation of Insurance Holding Companies

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Overview of Presentation

- Current Regulation of Insurance Holding Companies (IHC)
 - SEC
 - NAIC (Model Law #440 and Model Reg #450)
 - Federal Bank regulators – Federal Reserve, OTS, OCC
- The Dynamics Are Changing
 - Dodd-Frank Act
 - Financial Stability Oversight Council (FSOC)
 - Office of Financial Research (OFR)
 - Federal Insurance Office (FIO)
 - NAIC
 - Amendments to #440 and #450
 - Solvency Modernization Initiative (SMI)

- The SEC
 - Chairman (Mary Schapiro) + four other Commissioners
 - Staff of 3,700 to oversee 35,000 entities (800 more staff coming on board this year)
 - Regulates securities offerings (registration statement with signature of the CEO, CFO and board of directors)
 - Regulates stock markets and broker-dealers
 - Regulates investment companies (e.g., mutual funds and variable products) and investment advisers
 - Inspection staff and large enforcement staff
- Disclosure-based regulation: Standard is no material misstatements or omissions

- Scenario One: IHC issues shares of its own stocks and bonds to the public
 - “Public” company
 - Must update the market on management’s assessment of risk factors and the company’s financial condition
 - File Form 10-K annually, Form 10-Q quarterly and Form 8K, as necessary
 - Independent auditors
 - Audited consolidated GAAP financial statements and attestation on internal controls over financial reporting (like MAR)
 - Level of materiality: parent-company level

IHCs and the SEC

- Scenario Two: Insurer offers registered insurance products
 - If it is a variable product, then there are prohibitions on certain affiliated transactions
 - Fees and charges must be “reasonable”
 - Disclosure/registration of guarantees and support agreements
 - Disclosure of financial condition of the insurer
 - Compliance Rule (Rule 38a-1)
 - Annual updates to registration statements and audited financial statements of the insurance company and separate account
- No prudential regulation

- Model Law # 440 (“walls” approach)
 - Registration of the insurance company within the holding company system
 - Identification of material arrangements with affiliates, including loans and guarantees
 - Dividends paid, reinsurance
 - Regulation of any change in control
 - Transactions within the holding company with insurer must be fair and reasonable and fees must be reasonable
 - Insurer’s surplus must be reasonable
 - Limitations and restrictions on certain affiliated transactions (loans, extension of credit, guarantees, management agreements)
- Focus is on walling-off the insurance entity

- **Model Reg. #450**
 - Form A (Acquisitions)
 - Form B (Annual Registration of Insurance Company)
 - Form C (Summary Form)
 - Form D (Prior Notice of Transaction: Guarantees, Loans, Extensions of Credit, Reinsurance, Management and Cost-Sharing Agreements)
 - Form E (Pre-notice of mergers)
- **Model Audit Rule**
 - Can designate parent's SOX audit committee as insurer's audit committee, if SOX committee considers material weaknesses and significant deficiencies at the level of materiality of the insurance company

Changes on the Horizon: Dodd-Frank

- Title I of the Dodd-Frank Act establishes the Financial Stability Oversight Council
- What is the Council's Charge?
 - Identify risks to the financial stability of the US arising from the material financial distress or failure of large, interconnected bank holding companies or **non-bank financial companies (NFCs)**
 - Promote market discipline by eliminating expectations that the government will protect stakeholders (shareholders, creditors, depositors, counterparties) in failure of a major institution (eliminate "Too Big To Fail")
 - Respond to emerging threats to the stability of U.S. financial markets

- Who is on the Council?
 - 10 Voting Members from “Member Agencies”
 - Treasury Secretary, Fed Chair, Comptroller of the Currency, CFPB Director, SEC Chair, FDIC Chair, CFTC Chair, Federal Housing Finance Agency Chair, NCUA Chair, **Presidential appointee with insurance expertise**
 - 5 Non-voting members
 - Director of the Office of Financial Research (OFR), **Director of the Federal Insurance Office (FIO)**, **one State Insurance Commissioner**, one State Banking Commissioner, one State Securities Commissioner

- Insurance Expertise on the FSOC
 - Voting Member - Presidential Appointee
 - Non-Voting Members - FIO Director, State Insurance Commissioner
- Timing – When will appointee be named? When will appointee be confirmed?
- How will the insurance voting member interact with the NAIC and staff?

- What are the powers/duties of the Council?
 - Make recommendations to “member agencies” on general supervisory principles
 - Make recommendations to the Fed on the establishment of heightened prudential standards (risk-based capital, leverage, liquidity, contingent capital, resolution plans, concentration limits, disclosures)
 - Monitoring domestic and international financial regulatory proposals, including insurance
 - Collect information through OFR and FIO from virtually all state and federal regulatory agencies and give direction to OFR
- Mostly advisory and consultative role. Influence through role in setting the agenda and coordinator of rulemaking

- For Insurance Companies, the real power of the FSOC is its ability to designate “Non-Bank Financial Companies” to be supervised by Federal Reserve Board
- The definitions in the Dodd-Frank Act make it clear that even if all you do is an insurance business, you could be subject to a designation by the FSOC as a Board Supervised NFC
- Section 113 of the Dodd-Frank Act describes the process (appeals rights, annual re-evaluation)

- **Criteria for FSOC designation as a Board Supervised NFC**
 - A finding that material financial distress at the NFC, or the nature, scope, size, scale, concentration, interconnectedness or mix of business of the NFC, could pose a material threat to the financial stability of the United States
- **Who will the FSOC designate as a Board Supervised NFC and when will those designations be made?**
 - First meeting of the FSOC was October 1. It may be an early order of business.
 - Maybe the top 15-20 biggest insurance companies?
 - Will the test become “does the public recognize them”?

- What must an insurance company do when it is designated a Board Supervised NFC?
 - Register with the Federal Reserve Board
 - Submit reports to the Fed and disclose certain information to the public
 - Subject to examination and enforcement by the Fed
 - Comply with prudential standards set by the Fed
 - Develop a “living will”
 - Potential limits on acquisition activity

- Final thoughts on the FSOC and its impact on insurers:
 - Potential impact for insurance company clients even if they do not have any banking operations
 - Board Supervised NFCs have significant additional resource issues in order to (1) get registered, (2) comply with new regulatory scheme and regulator, including prohibited affiliated transactions
 - At the end of the day, the Fed really has the right to “manage your business” if you are a Board Supervised NFC, including heightened prudential standards (capital, leverage, liquidity)
 - All insurance companies (not just Board Supervised NFCs) will be subject to all sorts of additional information requests from many different directions. More scrutiny by tough regulators
 - Open question: How will designation as Board Supervised NFC interplay with NAIC requirements and with SEC requirements?

- What is the role of the OFR in the Dept of Treasury?
 - Support the FSOC; sit as non-voting member
 - Information gathering, research and analysis through a Data Center and a Research and Analysis Center
- Who heads the OFR?
 - Presidential appointee, approved by the Senate
 - 6-year term
 - Has sole discretion in fulfilling his/her duties
- What about the staff of the OFR?
 - Not subject to civil service salary caps
 - Fellowship Program for qualified academics and professionals
 - Post-employment prohibition

- What are the statutory duties of the OFR?
 - Collect data on behalf of FSOC
 - Standardize the types and formats of data reported and collected
 - Rulemaking authority
 - Member agencies “shall” implement regulations promulgated by OFR to standardize types and formats of data collected – includes state agencies?
 - Subpoena power
 - Perform applied research and long-term research
 - Develop tools for risk management and monitoring
 - Make results available to financial regulatory agencies

- What is the role of the Data Center?

- Collect, validate and maintain all data necessary to carry out its duties
 - Includes maintaining a database of financial companies (includes insurance companies) and financial instruments
- Require submission of periodic reports from any financial company
- Collect, on a schedule determined by the Director, in consultation with FSOC, financial transaction data and position data from financial companies (including insurance companies)
- Must first coordinate with existing agencies and rely on their information – but can standardize form and type of data

- What is the role of the Research and Analysis Center?
 - Develop and maintain metrics and reporting systems for risks to financial stability
 - Monitor and report on system wide risks
 - Conduct and sponsor research to improve regulation of financial entities
 - Evaluate stress tests
 - Maintain expertise
- Issues of confidentiality of data
- Impose data standards

- What is the role of the FIO in the Dept of Treasury?
 - Monitor all aspects of insurance industry
 - Recommend to FSOC any insurer, including parent and affiliates, as an entity to be a Board Supervised NFC
 - Represent the U.S. at the IAIS
 - Advise and assist Treasury Secretary in negotiating international treaties on prudential aspects of international insurance matters
 - Preempt state measures
 - Consult with states on matters of national importance
 - Provide national policymakers with access to key information and expertise on insurance sector

- Who heads the FIO?
 - Director, appointed by Secretary of the Treasury
 - Career-reserved position that does not require Senate approval
 - Non-voting member of FSOC
- What is the authority of the FIO?
 - Broad authority to gather information from insurers, parents and any affiliates, including risk management information
 - Director has subpoena power
 - Must coordinate in advance with relevant federal or state agency and public sources
 - Enables information-sharing agreements with state regulators

- Implications

- Sweeping powers of FIO (and OFR) to collect and analyze data gives Federal government the analytic tools to critically assess the adequacy and effectiveness of State insurance prudential measures
- Information currently provided to state regulators will now be analyzed by the FIO, OFR and FSOC. Insurers must now consider how that data will be interpreted
- By granting the Treasury Secretary the power to negotiate international insurance agreements, Dodd-Frank will accelerate the global supervision of insurance enterprises
- Insurers should pay closer attention to ways in which international agreements could impact their solvency (Basel III)
- Federal Insurance Charter? Study on improving insurance regulation due in January 2012

Changes to NAIC #440

- NAIC is seeking to focus the intellects and energies of directors on evolving risks facing insurers, as exemplified by financial crisis and ensuring recessionary economy
- Corporate Governance
 - Form B registration statement would include statement that board “[is responsible for and] oversees corporate governance and internal controls” and that
 - “officers or senior management have approved, implemented and continue to maintain and monitor corporate governance and internal control procedures.”

- Implications of statement on corporate governance
 - How does this statement fit with a director's duty of care and duty of loyalty?
 - Does the board's statement that it [is responsible for and] oversees internal controls now require the board to mitigate known business risks, such as those identified in the Annual Statement, ORSA or PBR process?
 - Will it be easier for shareholders (or contract owners) acting as plaintiffs to establish a failure to act in good faith?

- Annual Enterprise Risk Management Report on Financial and/or Reputational Contagion
 - An Annual Report would be filed with the NAIC each year by the ultimate controlling person, as a confidential supplement to Form B
 - Goal is to provide insurance regulators with a “window” on operations of the holding company
 - Item 9 to Form B would require ultimate controlling person to provide information to NAIC annually on:
 - Any material developments regarding “internal audit finding, compliance or risk management affecting the holding system”

- Ultimate holding company would provide the NAIC with information each year about:
 - Business plan of the insurance holding system and summarized strategies for the next 12 months
 - Information on corporate or parental guarantees throughout the holding company and expected source of liquidity should such guarantees be called upon
 - Identification of any negative movement or discussion with rating agencies
 - Any material activity or development in the holding company system that could adversely affect the insurance holding company system

Changes to NAIC #440

- Related expansion of commissioner's exam powers and access to books and records
 - Commissioner can order the insurer to provide information about an affiliate that is not in the insurer's possession
 - Commissioner can compel production of records and examine records of affiliates of the insurer, using subpoena powers enforceable in court
 - Commissioner can examine the insurer's affiliates
- Presumably, any information shared with the NAIC will also be shared with the FIO, OFR and FSOC
- Since the SEC is also a member of FSOC, will the SEC have access to the confidential Annual Reports?

Regulatory Challenges

- With a seat at the table of the new federal risk regulator, state insurance commissioners can be expected to flex their muscles and assert increased jurisdiction over IHCs
- How will the federal regulators respond?
 - Will the federal regulators ask for new categories of information – risk management metrics?
 - Insurers, especially those that are part of “public companies” and/or Board Supervised NFCs, will likely be called upon to manage and carefully consider new regulatory demands and uncertainties

Conclusion: It's all in the details...

- “It’s like taking the elephants over the Alps—it’s on that order of magnitude in terms of the task in front of all the regulators...the immutable fact is that a lot has got to change” Karen Shaw Petrou, Managing Partner of Federal Financial Analytics (*Washington Post*, July 14, 2010)

For More Information

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