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## Financial Regulatory Reform – A New Foundation: Building Financial Supervision and Regulation

### Potential Implications for Insurance Companies

The Obama Administration introduced its white paper, “Financial Regulatory Reform – A New Foundation: Building Financial Supervision and Regulation,”<sup>1</sup> (the White Paper) on June 17, 2009, proposing significant and comprehensive regulatory reform in response to what the White Paper calls the “most severe financial crisis since the Great Depression.”

The White Paper offers targeted recommendations intended to address the following five key goals: (1) *promote robust supervision and regulation of financial firms*, (2) *establish comprehensive supervision and regulation of financial markets*, (3) *protect consumers and investors from financial abuse*, (4) *improve tools for managing financial crises*, and (5) *raise international regulatory standards and improve international cooperation*.

### Insurance Regulation Under the White Paper

Recognizing that “insurance is a major component of the financial system,” the White Paper includes specific discussion and recommendations related to insurance but leaves many questions unanswered. The White Paper does not offer any express recommendations on some of the more controversial issues related to federal insurance regulation, such as the creation of a federal charter. Instead, the Administration chose to recommend the more politically expedient establishment of the Office of National Insurance (ONI)<sup>2</sup> within Treasury. The ONI would gather information, develop expertise, and be a point of contact for foreign regulators with the authority to negotiate international agreements at the federal level. Set forth below is a description of the specific insurance-related content of the White Paper, followed by a discussion of its “five pillars.” At the conclusion of each section, is a brief list of our thoughts about some of the possible implications for the insurance industry.

The White Paper also recommends modernizing the current system of insurance regulation consistent with six core principles. The White Paper does not recommend a specific proposal for a federal insurance charter<sup>3</sup> but “supports” proposals to enhance federal oversight of insurance regulation within the following six principles:

1. Effective, systemic risk regulation with respect to insurance;
2. Strong capital standards and an appropriate match between capital allocation and liabilities for all insurance companies;

<sup>1</sup> For a copy of the White Paper, please click the following link: [http://www.financialstability.gov/docs/regs/FinalReport\\_web.pdf](http://www.financialstability.gov/docs/regs/FinalReport_web.pdf).

<sup>2</sup> See SUTHERLAND LEGAL ALERT: “House Members Encourage the Creation of a National Insurance Office Within Treasury” (January 26, 2009) (Please click [here](#) to view the legal alert).

<sup>3</sup> For a description of current legislation in the House proposing the establishment of a federal charter, see SUTHERLAND LEGAL ALERT: “National Insurance Consumer Protection Act and Prospects for Federal Regulation of Insurance” (April 13, 2009) (Please click [here](#) to view the legal alert).

3. Meaningful and consistent consumer protection for insurance products and practices;
4. Increased national uniformity through either a federal charter or effective action by states;
5. Improve and broaden the regulation of insurance companies and affiliates on a consolidated basis, including those affiliates that are outside of the traditional insurance business (asserting that this may help address “AIG-type” problems in the future); and
6. International coordination.

Other aspects of the proposal, though not specifically targeted at insurers, would have significant impact on insurers and their holding companies.

## Robust Supervision and Regulation of Financial Institutions

As part of the effort to strengthen and augment the existing regulatory framework, the White Paper recommends restructuring the federal financial regulatory system, including the formation of new agencies and coordinating bodies, a new consolidated bank regulator, and a more powerful Federal Reserve. A primary goal of the reforms proffered in the White Paper is to ensure the stability and strength of financial institutions, in part by imposing stronger, more consistent capital, liquidity and leverage requirements on all financial institutions, with higher standards applying to any large, interconnected institutions. Significant elements of the restructuring include:

1. A new Financial Services Oversight Council (FSOC), chaired by the Treasury Secretary with the principal federal financial regulators<sup>4</sup> as members, would be responsible for improving information sharing and coordination among key federal regulatory agencies on policy development, supervision and identifying emerging systemic risks and regulatory gaps. The FSOC would have authority to require periodic and other reports from any U.S. financial institution, regardless of whether the institution is federally regulated. A subset of the council’s membership would be responsible for determining whether to invoke resolution authority with respect to large, interconnected institutions.
2. New authority would be given to the Federal Reserve granting it consolidated supervision over large, potentially “too-big-to-fail” institutions that could pose a threat to financial system stability – so-called Tier 1 Financial Holding Companies (FHCs) – regardless of whether such institutions own a bank or other depository institution. The White Paper proposes that this designation would be ultimately determined by the Federal Reserve, within legislative and regulatory guidelines, and need not be determined by specific asset levels. The Federal Reserve would consider recommendations by the FSOC and, in the case of insurers, the ONI of such designations. Federal Reserve supervision would extend to all FHCs, bank holding companies (BHCs) and all of their subsidiaries without taking into account whether such entities are otherwise regulated or U.S.-based.<sup>5</sup> While potentially applicable to insurers and their holding companies, the White Paper also recommends that any investment banks or their holding companies, subject to consolidated supervision, should be regulated by the Federal Reserve, rather than the SEC.

<sup>4</sup> The members, in addition to the Treasury Secretary, include the heads of the following: the Board of Governors of the Federal Reserve System, the National Bank Supervisor, the Consumer Financial Protection Agency, the Securities and Exchange Commission (SEC), the Commodity Futures Trading Commission (CFTC), the Federal Deposit Insurance Corporation (FDIC), and the Federal Housing Finance Agency.

<sup>5</sup> The White Paper acknowledges that allowing the Federal Reserve the power to obtain information or impose prudential restrictions on regulated subsidiaries that already have a primary supervisor, e.g., banks, broker-dealers, investment advisers, futures commission merchants and insurers, would require an amendment to the Gramm-Leach-Bliley Act’s provisions intended to provide for “functional regulation” of an FHC’s or a BHC’s regulated subsidiaries.

3. A new National Bank Supervisor, which would be a separate agency within the Treasury, would supervise all federally chartered depository institutions and all federal branches and agencies of foreign banks. The White Paper proposes eliminating the federal thrift charter and nonbank bank loopholes available to, among others, trust companies and industrial loan companies, which permitted owners of these institutions, including insurance complexes, to avoid the limitations and requirements imposed on BHCs by the Federal Reserve.
4. Advisers of hedge funds and other private pools of capital with a certain amount of assets under management would be required to register with the SEC under the Investment Advisers Act of 1940. Other recommendations include harmonization of investment adviser and broker-dealer regulation and imposing fiduciary duties on broker-dealers that “provide investment advice” to their customers.<sup>6</sup>
5. A new, independent Consumer Financial Protection Agency (CFPA) would have the authority to regulate and supervise consumer financial services and investment markets.
6. A new resolution regime, modeled after the FDIC’s existing resolution authority for depository institutions, would be put in place for failing bank holding companies (including all FHCs) and Tier 1 FHCs if a disorderly resolution could have a serious adverse effect on the financial system or economy.
7. As previously noted, the ONI would be established to address the lack of expertise within the federal government regarding the insurance industry and to develop a modern regulatory framework for insurance.

### Implications for the Insurance Industry

- Any insurance company complexes that include federal thrifts, trusts or other nonbank banks would become FHCs subject to consolidated supervision by the Federal Reserve.
- Insurance holding companies deemed systemically important could be deemed Tier 1 FHCs, regardless of whether or not they owned a bank, thrift or nonbank bank. Therefore, if an insurer sells or otherwise disposes of its banking affiliate, it could remain subject to Federal Reserve oversight.
- Consequences of regulation as an FHC or Tier 1 FHC include: significant capital, asset, liquidity management and earnings requirements at the holding company level; consolidated supervision of not only the FHC but also its regulated and unregulated subsidiaries (including insurance companies); regulation of executive compensation; being subjected to federal enforcement powers and procedures; and possible application of accounting standards, including fair value accounting rules and limitations on activities among affiliates.
- The extent to which Federal Reserve regulation could impact or preempt state insurance capital and reserve requirements is unclear.
- In addition to federal regulation, insurers and their holding companies that are part of an FHC or Tier 1 FHC structure would be subject to overlapping state insurance regulation.
- Insurers and their holding companies would be subject to policies established by international agreements negotiated by ONI relating to the insurance industry.
- The insurance industry would have no representation on the FSOC as there is no role for state insurance regulators, the National Association of Insurance Commissioners (NAIC), or even the ONI.

<sup>6</sup> It is unclear whether the White Paper proposes to impose a fiduciary duty on broker-dealers whose investment advice is “solely incidental” to their broker-dealer services.

## Comprehensive Supervision of Financial Markets

The White Paper proposes greater regulation and robust reporting requirements on securitizations, as well as a requirement that issuers and sponsors retain a financial interest. The White Paper also proposes stronger regulation of credit rating agencies and comprehensive regulation and oversight with respect to all over-the-counter derivatives and derivatives dealers, including capital requirements (in addition to those currently imposed by bank regulators) and required compliance with anti-manipulation and abuse rules. All over-the-counter contracts should be traded through regulated centralized counterparties with standardized products that would be moved to regulated exchanges or other transparent electronic trading facilities. The proposal stresses the importance of harmonizing regulation of the securities and futures markets, especially in light of the growing derivatives market, and calls for the SEC and the CFTC to make recommendations as to how to accomplish such harmonization. Finally, the White Paper advises granting new authority to the Federal Reserve to oversee payment, clearing, and settlement systems and related activities.

### Implications for the Insurance Industry

- Higher level of regulation of securitizations and asset-backed securities transactions, which may include retention of liabilities with respect to assets sold.
- Additional regulation of and limits on over-the-counter transactions and requiring transactions to be cleared or traded on exchanges may impose additional strains on liquidity due to margin or collateral requirements, may increase trading costs due to brokerage fees, and may limit the ability to meet business, tax and accounting requirements for hedge treatment.

## Protection of Consumers and Investors

The CFPA would be created to protect consumers in the financial products and services markets, except for investment products and services already regulated by the SEC or CFTC. The primary objective of the CFPA is to protect consumers in the *credit*, *savings*, and *payments* markets from unfair, deceptive, and abusive practices. Fixed annuities are not specifically identified as a savings product subject to the CFPA's jurisdiction and oversight. However, press reports and other sources, including an "Op-Ed" piece co-authored by Treasury Secretary Timothy F. Geithner and Director of the National Economic Council Lawrence H. Summers,<sup>7</sup> have referred to annuities as products that could be covered by the CFPA. The CFPA would have rulemaking authority, as well as supervisory and enforcement authority, over all covered products and the institutions that issue, provide or service such products.

With the help of a Financial Consumer Coordinating Council (made up of federal and state consumer protection agencies), the White Paper suggests that the CFPA should coordinate enforcement with the states and that the states should be able to "adopt and enforce *stricter* laws for institutions of all types, regardless of charter, and to enforce federal law concurrently with respect to institutions of all types, also regardless of charter." The latter would seem to undermine the well-established preemptive authority that has been exercised by federal bank regulators when faced with state regulations and laws that impact the activities of federally chartered banks. The White Paper promotes improvements to the "transparency, fairness, and appropriateness" and higher standards for all consumer financial products and services

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<sup>7</sup> For a copy of the Op-Ed, please click the following link: [http://www.financialstability.gov/latest/06142009\\_wp.html](http://www.financialstability.gov/latest/06142009_wp.html); see also, *The Wall Street Journal* p. 1, (June 18, 2009).

providers. The Administration believes that the CFPA should apply consistent regulation to similar products.

The Administration proposes to enhance the role of the SEC. Particularly, the Administration believes that the SEC should be given expanded authority to promote transparency in disclosures to investors by requiring, for example, that prospectuses be given to investors before the sale so that the investor can make an informed decision at the point of sale. The Administration also proposes that the SEC should be given new tools to promote fair treatment of investors by establishing a “fiduciary duty for broker-dealers offering investment advice and harmonizing the regulation of investment advisers and broker-dealers” and by prohibiting mandatory arbitration clauses in broker-dealer and investment advisory accounts with retail customers.

### Implications for the Insurance Industry

- Since the White Paper repeatedly refers to “reducing gaps” in federal supervision and jurisdictional reach over the “institutions that issue, provide or service” the covered products, it appears likely that the CFPA’s jurisdiction would extend to insurers and their producers if fixed annuities are deemed to be covered products.
- The White Paper also suggests that the government should do more to “promote ‘plain vanilla’ products,” and the CFPA should have the authority to “define standards” for those products and “require firms to offer them” with other lawful products. If fixed annuities are covered products, query whether: (1) all fixed annuity issuers and producers would be required to offer a “base” contract to each potential client; and (2) the “base” contract, as a result of being “blessed” by the CFPA, would be deemed suitable for every customer?
- Since the White Paper recommends that “states should be the first line of defense” for supervisory and enforcement authority, and also recommends that states should be able to enforce the regulations promulgated by the CFPA, insurers and producers could be subject to enforcement of both state insurance laws and CFPA guidance, from state insurance regulatory authorities.
- The Administration proposes authorizing the CFPA to adopt regulations subject to the Administrative Procedures Act, including “disclosures or restrictions on contract terms or sales practices” that would apply to any covered providers of such products. As a result, it seems possible that the CFPA could have a significant impact on fixed annuities in terms of sales practices and even permissible terms of the contracts and could add a new layer of regulation beyond the existing state insurance requirements.
- Mortgage and consumer lending by insurers and their affiliates, as well as deposit taking by an insurer’s depository institution affiliates, would be subject to the regulations of the CFPA, in addition to more stringent state regulations of that activity.
- Insurer broker-dealer affiliates and their registered representatives could be subject to higher standards of conduct in their marketing activities.
- Insurers and their distributors of securities products would be exposed to potentially higher litigation risk if arbitration of investor disputes cannot be required.

### Tools for the government to manage financial crises

The White Paper suggests granting the U.S. government additional authority, modeled on the existing authority of the FDIC, to resolve potential failures of BHCs and Tier 1 FHCs if the failure could have serious consequences for the financial system or the economy. This authority would not replace the ability to pursue bankruptcy (or, we assume, insolvency procedures that might be available under state insurance laws if the Tier 1 FHC is an insurer), but rather is based on the FDIC’s current “systemic risk

exception,” which allows it to resolve institutions and not be subject to the typical least cost standard when systemic financial stability is at stake. The White Paper recommends that the Treasury, after consulting with the president and having the recommendations of two-thirds of the board members of the FDIC and of the Federal Reserve, can require resolution of the institution; if the largest subsidiary by assets is a broker-dealer, then FDIC approval is not required and two-thirds of the SEC’s commissioners must approve. The Treasury generally should appoint the FDIC as receiver or conservator, though the SEC could be appointed if the largest subsidiary of the failing institution is a broker-dealer. In the event the failing institution includes an insurer, the ONI will provide consultation to the Federal Reserve and FDIC boards on insurance-specific matters.

In order to improve accountability, the White Paper also proposes amending the Federal Reserve Act to require the Treasury Secretary’s prior approval for the Federal Reserve to exercise certain emergency lending authority to any individual, partnership, or corporation under “unusual or exigent circumstances.”

#### Implications for the Insurance Industry

- Tier 1 FHCs that own insurers or are insurers could be forced into resolution by the Treasury without the approval of their domiciliary insurance regulator.
- The FDIC would likely be the receiver or conservator of the failed insurance-related institution.

#### International Cooperation

The White Paper highlights the importance of reaching an international consensus in four core areas: regulatory capital standards, oversight of global financial markets, coordinating supervision of internationally active financial firms, and crisis management and prevention. The proposed reforms on international cooperation are intended to be consistent with U.S. commitments made as part of the G-20 process.

The Federal Reserve, in consultation with the Treasury, would develop rules to identify foreign financial institutions that should be Tier 1 FHCs, based on whether or not their U.S. operations pose a threat to financial stability. The Federal Reserve could apply the criteria to the world-wide operations of the foreign institution, only to the U.S. operations of the foreign institution, or only to those operations of the foreign institution that affect the U.S. financial markets. In reaching its determination, the Federal Reserve should take into account the national treatment and equality of competitive opportunity for the foreign institutions based in the United States and U.S.-based institutions, as well as international agreements negotiated by the executive branch. Once designated, foreign institutions may be required to meet the same capital and management test as U.S. institutions, as is the case with current FHCs and their U.S. subsidiary banks or U.S. branches. How these rules would apply will be determined by the Federal Reserve in consultation with the Treasury.

The White Paper recommends that the Financial Stability Board (FSB) and U.S. authorities enhance the supervision of significant global financial institutions through the establishment and continued development of supervisory colleges consisting of the regulators of such institutions in various countries.<sup>8</sup> The White Paper notes that the United States is the only country in the International Association of

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<sup>8</sup> The NAIC, in coordination with Treasury, has designated certain individual state insurance regulators to convene supervisory colleges for insurance-based global financial institutions based in the United States, which may act as the representative of the United States in supervisory colleges convened under the auspices of the International Association of Insurance Supervisors in other countries.

Insurance Supervisors that is not represented by “a federal insurance regulatory entity to speak with one voice” and proposes that the ONI fulfill that role in the future.

The White Paper supports the directive of the G-20 that the accounting standard setters quickly improve the standards for the valuation of financial instruments and reduce the complexity of financial instruments accounting. First, the White Paper recommends that the Financial Accounting Standards Board (FASB) and the International Accounting Standards Board (IASB) clarify and make consistent the application of fair value accounting standards, including the impairment of financial instruments, by the end of 2009. Second, the FASB and the IASB should improve accounting standards for loan loss provisioning and make it more forward-looking without sacrificing the transparency of financial statements. Finally, the White Paper recommends that the IASB and FASB make substantial progress by the end of 2009 toward developing a single set of high-quality global accounting standards, with the objective of achieving broad convergence of international financial reporting standards (IFRS) and U.S. generally accepted accounting principles (GAAP) by the end of 2010, which is a necessary precondition under the SEC’s proposed roadmap to adopt IFRS.

#### Implications for the Insurance Industry

- Foreign insurer holding companies and their U.S. subsidiaries could become subject to the stringent regulatory requirements imposed on U.S.-based Tier 1 FHCs.
- U.S. insurance companies that are part of significant global financial institutions can expect to be subject to enhanced supervision through cross-border supervisory colleges.
- Because IFRS will not issue a specific standard or interpretation on the accounting treatment for “insurance contracts” until the IASB and FASB complete their joint project (in 2010 at the earliest), mandatory adoption of IFRS by the SEC before such standards are complete may not achieve the purpose of developing high-quality global accounting standards for the insurance industry.



*We will continue to monitor developments related to the regulatory reform initiatives affecting our insurance company clients. If you have questions regarding this Legal Alert, please feel free to contact any of the attorneys listed below or the Sutherland attorneys with whom you regularly work.*

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