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Contemplating A US Insurance Super-Regulator

Law360, New York (August 24, 2009) -- The Obama administration's plan for a federal "systemic risk" regulator as a means of preventing another credit meltdown could have significant long-term effects on insurance regulation in the U.S.

Although Treasury Secretary Geitner has so far offered scant details on how the new regulatory czar will interface with 54 insurance regulators from Maine to Arizona (not to mention Puerto Rico and Guam), in recent congressional testimony he managed to both endorse the concept of an optional federal charter for insurers and simultaneously pay respects to the historic role state insurance regulators have played.

Before Congress rushes headlong into legislating major new power over insurers for some federal official or body — be it Secretary Geithner, the Federal Reserve, the FDIC or some new agency — with numerous and severe unintended consequences, we think it useful to consider how placing a new layer of federal oversight on top of the existing state regulatory apparatus is a prescription for regulatory chaos, not a worthwhile reform.

Though the specific details must await the actual legislation, the administration's white paper on financial regulatory reform released June 17 devotes relatively little attention to insurers, but focuses mainly on banks, securities firms, consumer lending, mortgage brokers and derivatives.

The administration takes no position on an optional federal charter for insurance companies, although it acknowledges that the current state-based system is "highly fragmented, inconsistent and inefficient."

The main insurance initiative in the white paper is creating an Office of National Insurance within the Treasury Department.

The office would monitor insurance industry developments, act as a central clearinghouse for insurance industry information for Congress and the executive branch, and negotiate international insurance agreements on behalf of the government.

Exactly how the ONI would interact with 54 state and territorial regulators is left unsaid.

One other potential role for ONI, according to the white paper, is to refer to the Federal Reserve for solvency regulation large insurance companies whose impairment would jeopardize the stability of the financial markets as a whole.

Again, how the Federal Reserve would integrate and coordinate its oversight of these insurers with existing state rules must await the actual terms of the legislation and implementing regulations.

Secretary Geithner seems to overlook the fact that an insurer whose failure would pose systemic risk is surely so large that it is currently regulated by numerous states, each of whom has the power to thoroughly examine its finances and its management.

Presumably the domestic regulator of that insurer has already led a team of examiners from a number of states, aided by one or more outside auditing and actuarial firms, in deciding whether the insurer should be the subject of state insurer delinquency proceedings.

How does the Secretary propose to decide whether the existing state regulators have acted correctly if the regulators decide that rehabilitation or liquidation proceedings are not warranted based on their analysis of the insurer's assets and projected liabilities?

Does Washington have a set of actuarial tools that are so much better than risk-based capital and other solvency metrics which state regulators now routinely employ, and, if so, why haven't these been shared with the states?

State regulators have long had the power to disapprove both insurer investments and transactions with parents and affiliates. Should the Secretary of the Treasury in effect overrule decisions allowing those investments and intercompany transactions?

If federal officials decide that an insurer has underwritten too much risk, do they then countermand prior state regulatory approvals, such that property owners in, say, Florida and Louisiana should suddenly have their policies cancelled or nonrenewed, even though regulators in both states had allowed — indeed encouraged — those policies to be written?

Will Secretary Geithner or some other federal super-regulator order a troubled insurer to significantly raise its rates to counter projected losses without regard to state rate and form rules?

Conversely, if state rehabilitation or liquidation proceedings have already been commenced against an insurer in financially hazardous condition, what does the United States government do then?

Does the government displace the supervising state court and the state insurance commissioners acting as receivers in deciding whether the insurer can receive various forms of capital injections and/or loans to enable it to survive?

Does it rewrite Section 109 of the Bankruptcy Code to allow insurers to be the subject of Chapter 7 or Chapter 11 proceedings in federal bankruptcy court, with all state court proceedings terminated?

Once the Bankruptcy Court takes over, how would the state guaranty funds interact with a federal bankruptcy court which decides what insurance claims get paid and in what amounts, and would the funds be treated as policyholders or general creditors?

To ask these questions should lead to the conclusion that merely layering a new federal systemic risk regulator on top of the existing state-based regime is likely to result in disruptive confrontations between state and federal officials over who knows best how to deal with large troubled insurers.

Policyholders, claimants, reinsurers and other creditors will not be well-served by an illusory reform that seems like a lawyer's dream and a nightmare for everyone else.

No doubt Congress has the constitutional power under the Commerce and Supremacy Clauses of the Constitution to enact what the administration seeks. The question is whether that would be wise.

The impetus for Treasury's push for new regulation did not come because an insurer was in danger of defaulting on regulated insurance contracts.

It came because no insurance regulator anywhere in the world had the power to supervise a firm that executed 1.5 trillion dollars in credit default swaps which were not deemed to be insurance contracts either in the U.S. or any other country.

A compelling argument can be made that if AIG financial products had been subject to the same solvency rules and oversight as licensed financial guaranty insurance companies, it would not have been able to undertake the devastating levels of risk that it did.

Thus, the rationale for creating a whole new layer of regulation for insurers, with all the difficulties and uncertainties that dual regulation portend, does not seem so clear.

There are sound arguments for and against providing all U.S. insurers with the option to be regulated solely by the federal government.

If, however, the national interest will be best served by having a federal super-regulator for certain very large insurers — to minimize the risk that that their impairment will mean a national financial meltdown — then it would seem logical for at least those insurers to be regulated entirely at the federal level.

Only in that way can the single systemic risk regulator effectively and expediently operate without the inevitable friction and damaging delays inherent in one federal official or bankruptcy judge trying to supersede numerous state insurance regulators on core solvency issues.

Only in that way can regulators in the G-20 countries, who have pledged greater coordination, effectively work with a U.S. counterpart to save an impaired insurer or, failing that, to orderly liquidate it — a result impossible to achieve if numerous state officials claim jurisdiction over that insurance company.

If the viability of a particular insurance company is truly vital to the nation's economic health, then the Congress should legislate a single national authority to oversee all aspects of that insurer's operations. Otherwise, Treasury's flawed proposal will mean one regulator too many.

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