

The Evolution Will Not Be Televised: Detecting Patterns in the Ongoing Insurance Regulatory Policy Response to the 2008 Financial Crisis

By Daniel A. Rabinowitz

To purchasers of insurance products and services, insurance regulation may call to mind Churchill's remark about Russia—a riddle, wrapped in a mystery, inside an enigma. At first glance, the financial crisis of 2008 seems only to have made insurance regulation more opaque. For example, the passage of the Dodd-Frank Wall Street Reform and Consumer Protection Act,¹ the most visible public policy response to the crisis, has been a seismic event for the nation's banks and derivatives markets and lingers as a political issue even today.² Yet despite Dodd-Frank's numerous provisions affecting insurance, the insurance industry and insurance consumers are not nearly as directly affected by the legislation as are other financial sectors. The Bureau of Consumer Financial Protection (the "BCFP"), created by Dodd-Frank as the new federal watchdog agency overseeing consumer finance, does not even have jurisdiction over insurance.³ Insurance regulation continues, in other words, to evolve largely below the radar, and still predominantly at the state level, having never emerged as a meaningful issue in national electoral politics, even in the post-2008 era.

However, in recent legislative developments occurring both at the state and national levels, we can trace the main outlines of modern insurance regulation and can discern a response to the 2008 crisis just as significant as that occurring in other financial services. The response, consisting largely of an expansion of regulatory authority, tracks the three areas that comprise the main public policy objectives of insurance law. One is consumer protection (or "market conduct"), another is the solvency of particular insurance firms (or so-called "prudential" regulation), and the third is the viability of the insurance marketplace. Insurance law and the regulators who administer it can claim to be informed largely by these three objectives. By the same token, these can be in tension with one another in any given case, and, furthermore, these certainly do not provide automatic justification for any particular use of insurance regulatory discretion.

Consumer protection is the aspect of insurance law most tangibly affecting consumers of insurance. Historically, one of the principal aspects of insurance regulators' oversight of market conduct has involved the offer and sale of insurance policies. As an example of a market-conduct policy response to the 2008 crisis, New York's 2010 legislation⁴ merging the state's Insurance Department and

Banking Department and creating a new Department of Financial Services meaningfully enhances the regulator's ability to police the marketing and selling of insurance products. The legislation introduces a new term, "financial product or service,"⁵ defined as

any financial product or financial service offered or provided by any person regulated or required to be regulated by the superintendent pursuant to the banking law or the insurance law or any financial product or service offered or sold to consumers except financial products or services: (i) regulated under the exclusive jurisdiction of a federal agency or authority, (ii) regulated for the purpose of consumer or investor protection by any other state agency, state department or state public authority, or (iii) where rules or regulations promulgated by the superintendent on such financial product or service would be preempted by federal law.⁶

The New York law confers authority on the new state Superintendent of Financial Services to penalize "any intentional fraud or intentional misrepresentation of a material fact with respect to a financial product or service or involving any person offering to provide or providing financial products or services."⁷

One noteworthy aspect of the New York legislation's potential reach involves Dodd-Frank's establishment of the new BCFP and related consumer-protection provisions. The New York Superintendent's authority over insurance products is unassailable insofar as insurance products are "required to be regulated by the superintendent pursuant to...the insurance law." However, the exceptions for federally regulated products—*i.e.*, cases where the federal government has "exclusive jurisdiction" or where the superintendent's rules would be "preempted"—may be difficult in some cases to harmonize with the provisions of Dodd-Frank establishing the BCFP. For instance, while the BCFP represents the federal government's most ambitious effort yet to regulate the financial sector, the provisions of Title X of Dodd-Frank (establishing the BCFP) are replete with references to

cooperation and consultation with states.⁸ As a general matter, one may conclude that Title X of Dodd-Frank does not vest the federal government with much *exclusive* jurisdiction at all. Furthermore, Dodd-Frank's provisions on when "state financial consumer protection law[s]" may be preempted are narrow indeed.⁹ The net result of all this may be an increasingly muscular state financial regulatory function, at least in New York.¹⁰

Solvency regulation has become a flashpoint in the post-crisis era. One aspect of Dodd-Frank that does bear directly on insurers is so-called "systemic risk" regulation, *i.e.*, the ability of the federal government to designate certain non-banks as entities that should be subjected to heightened prudential standards enforced by the Board of Governors of the Federal Reserve System.¹¹ Observers have speculated on the extent to which insurers will be so designated and the impact that this could have on such firms and on insurance markets generally.¹²

State insurance laws are also oriented toward solvency concerns. Statutes such as those governing insurers' investment concentrations¹³ and "risk-based" capital adequacy¹⁴ largely involve quantitative elements of an insurer's financial condition, requiring compliance with certain financial metrics. Of course, solvency itself is the province of state insurance law—insurers are not eligible to be debtors under the federal Bankruptcy Code,¹⁵ and their insolvencies are presided over by state courts, administered by state regulators and governed by state insurance laws.¹⁶

Another critical way in which states oversee the financial health of insurers is through the regulation of insurance holding companies, and here can be seen most vividly policymakers' response to the 2008 crisis from the standpoint of prudential regulation. Most states have adopted a version of a model law published by the National Association of Insurance Commissioners (the "NAIC") entitled the "Insurance Holding Company System Regulatory Act,"¹⁷ which historically imposed guidelines on relationships between insurers and their affiliate companies. As originally adopted, the Holding Company Act vested broad discretion in the state insurance regulator regarding proposed acquisitions of insurers domiciled in his or her state and also regarding proposed material transactions between such insurers and those controlling the insurer. Every insurer, in fact, that is controlled by any other person or entity (including a holding company) must register and provide annual information to the domiciliary regulator under most states' version of the model Holding Company Act. The policy underlying these requirements included the prevention of "looting" or other misappropriation of insurance company surplus, as well as ensuring that those in control of insurance

company corporate affairs were persons of integrity. These concerns are ultimately directed at safeguarding the financial soundness of the insurer.

In December 2010 the NAIC adopted major changes to the Holding Company Act.¹⁸ The changes effectively transform the model law from one regulating relationships *between* insurers and affiliates to one regulating the health of the insurer's consolidated group *taken as a whole*. The amendments introduce the concept of "enterprise risk" (defined, generally, as any "activity, circumstance, event or series of events involving one or more affiliates of an insurer that, if not remedied promptly, is likely to have a material adverse effect upon the financial condition or liquidity of the insurer or its insurance holding company system as a whole...").¹⁹ This concept marks a key policy response to the financial crisis of 2008, which, in the eyes of some public officials, revealed that insurers were at risk not necessarily from any internal mismanagement but rather from the prospect of financial "contagion" resulting from the mismanagement of affiliated companies.

Other changes effected by the amended Holding Company Act include increased restrictions on transactions with affiliates (such as new requirements for regulatory filings and/or approvals in order to divest control over an insurer²⁰ and expanding the types of inter-affiliate transactions requiring prior notification to and approval by regulators²¹). The amendments also contemplate regulators from multiple states²² and even from non-U.S. jurisdictions²³ collaborating on oversight of insurance groups that straddle state and national boundaries. Again, these changes are all motivated by the perceived need to increase the supervision of insurance companies' financial condition and overall viability.

As states begin to adopt the amended Holding Company Act,²⁴ the policy debate will surely continue as to whether this kind of oversight of group-wide risks is effective, desirable or even feasible. Nevertheless, by codifying the expansive notion of "enterprise risk" and by implementing other enhancements to regulatory discretion, the NAIC has certainly illustrated in stark fashion its renewed focus on solvency concerns, and in this respect has echoed somewhat the federal government's response on systemically important banks.

The final pillar of insurance regulatory philosophy, the promotion of an **effective marketplace**, can best be seen in recent events in the provisions of Dodd-Frank governing surplus lines and reinsurance, known as the Nonadmitted and Reinsurance Reform Act of 2010, or "NRRRA."²⁵ These provisions, which had been considered as separate legislation by Congress in 2007 and 2009 prior

to being incorporated into Dodd-Frank, have the effect of harmonizing state laws by eliminating extraterritorial application of requirements governing surplus lines (generally, insurance coverage for unique risks for which coverage is unavailable in the regular, or “admitted,” insurance market) and reinsurance (the placing of insurance risks in an insurer’s portfolio by that insurer with a second insurer, the “reinsurer”). Generally, these provisions prevent multiple states from regulating the same transaction of surplus lines business or reinsurance, vesting this power in the state of domicile of the insured (in the case of the surplus lines provisions) or ceding insurer (in the case of the reinsurance provisions), as the case may be.

A number of distinct dynamics are at work here. These provisions have been hailed by industry as bringing needed reforms to the state-by-state patchwork of state laws in these matters.²⁶ The NAIC, naturally the most adamant defender of the state regulatory system and the fiercest opponent of federalizing insurance regulation, accepts the harmonization represented by the NIRA ostensibly to demonstrate the resilience of state insurance law and state regulators’ responsiveness to changing conditions.²⁷ Meanwhile, proponents of federal insurance regulation can point to Dodd-Frank’s other insurance-related provisions—including the establishment of a new Federal Insurance Office,²⁸ the possible designation of insurers as entities warranting heightened, federal scrutiny;²⁹ and even the ability (under certain limited circumstances) for the Federal Deposit Insurance Corporation to administer state insurance insolvency proceedings.³⁰

However, yet another prism through which to view the NIRA is that of marketplace efficiency. The NIRA improves market functioning without, strictly speaking, “deregulating”; it merely restricts the number of regulators that have a bite at the apple over any single transaction within the spheres of surplus lines and reinsurance. Although NIRA does represent an elegant and needed series of reforms, it is unclear to what extent NIRA is a useful template for reforms in other areas of insurance or financial services generally. The main reason for this is that the NIRA’s subject matter resides outside the scope of retail insurance regulation. Confined to commercial purchasers of specialty coverages and to insurers purchasing protection on their own risks, these provisions are largely irrelevant to the individual consumer. A failure of these provisions to work effectively would likely have little if any direct effect on retail purchasers of insurance or policyholders. Accordingly, there is little at stake politically for policymakers, a luxury that they would be less likely to enjoy in other areas of insurance law reform.

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What does this all mean for the consumer of insurance? Very little of this evolutionary change in insurance law is likely to have any direct, tangible consequence on actual insurance activity in the economy, at least immediately. After all, even in the one area of regulation having the most direct impact on consumer affairs, market conduct, the changes explored herein should not result in significant alterations to policy forms or coverages made available by insurers or services provided to policyholders. However, insurers themselves face a more complex, and in many ways more challenging, compliance environment than they have had to navigate in the past. As Dodd-Frank, NAIC model acts and other regulatory changes are implemented in insurance—and as states and the federal government continue to jockey for primacy in the area of insurance regulation—time will tell whether this evolution of insurance law is ready for prime time.

Endnotes

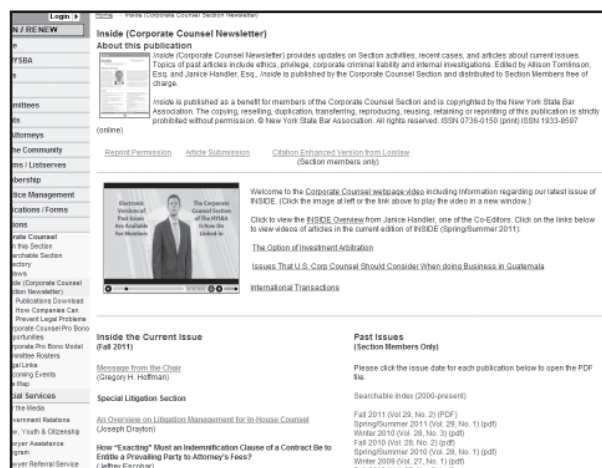
1. Public Law 111-203 (hereinafter cited as “Dodd-Frank Act”).
2. The author’s colleague at Chadbourne & Parke LLP, Adam Gale, writes about aspects of Dodd-Frank elsewhere in this issue of *Inside*.
3. Dodd-Frank Act §1002(15)(C)(i).
4. Chap. 62 of New York Laws of 2011.
5. NY Fin. Serv. Law §104(2).
6. *Id.*
7. *Id.*, §408(a)(1)(A).
8. *See, e.g.*, Dodd-Frank Act §1013(b)(3)(B), §1013(b)(3)(D), §1015.
9. Dodd-Frank Act §1044(a) prescribes that a state consumer financial law is preempted only if its application would have a discriminatory effect on a federally chartered bank or branch, the state law “prevents or significantly interferes with the exercise” by such a bank of its powers, or the state law is preempted by some other provision of federal law.
10. For a journalistic account of the new department’s function, *see* Liz Rappaport, “A New Watcher On Wall Street,” in *The Wall Street Journal*, October 3, 2011.
11. Dodd-Frank Act §115.
12. For examples of commentary and coverage on this topic, *see* Sean P. Carr, “Industry Calls for Specifics as FSOC Looks to Delay Systemic Risk Rules,” *BestWire*, September 19, 2011, A.M. Best Company, Inc.; Fran Lysiak, “Csiszar: Federal Regulators Have Looked Like Keystone Kops,” *BestWire*, February 28, 2011, A.M. Best Company, Inc.; “US Reform could be a positive: S&P,” *Reactions*, August 11, 2010.
13. *See, e.g.*, New York Ins. Law Art. 14.
14. *See, e.g.*, New York Ins. Law §§1322, 1324.
15. 11 U.S.C. §109(b)(2) and §109(b)(3)(A).
16. *See, e.g.*, New York Ins. Law Art. 74.
17. NAIC Model Laws, Regulations and Guidelines 440-1 (hereinafter cited as “Model Act”); *see also* Insurance Holding Company Sys-

tem Model Regulation With Reporting Forms and Instructions, at NAIC Model Laws, Regulations and Guidelines 450-1).

18. Joint Executive Committee/Plenary Conference Call, Natl. Assoc. of Ins. Commissioners, December 16, 2011.
19. Model Act §1(F).
20. *Id.*, §3(A)(2).
21. *Id.*, §5(A).
22. *Id.*, §3(D)(3).
23. *Id.*, §7.
24. As of this writing, Texas, Rhode Island and West Virginia have adopted the amendments. *See* 2011 Texas S.B. 1431; 2011 West Va. S.B. 253; 2011 R.I. H.B. 5730. Indiana has adopted one relatively minor aspect of the amendments (*see* 2011 Indiana H.B. 1486, signed into law on April 6, 2011 as Ind. Public Law No 11-2011), while Florida considered but ultimately did not adopt the amendments in its most recent legislative session. 2011 Fla. H.B. 1167.
25. Dodd-Frank Act, Title V, Subtitle B.
26. *See, e.g.*, "Testimony for the Record of the National Association of Professional Surplus Lines Offices Before the House Financial Services Subcommittee on Insurance, Housing and Community Opportunity Hearing Entitled, 'Insurance Oversight: Policy Implications for Consumers, Businesses and Jobs,'" Natl. Assoc. of Professional Surplus Lines Offices, Ltd., July 28, 2011; "PCI Calls for State Coordinated Response to Surplus Lines Reform" (press release), Property Casualty Insurers Assoc. of America, November 9, 2010.
27. *See, e.g.*, "Surplus Lines: NIMA, SLIMPACT & Next Steps" (slide presentation), James J. Donelan, Insurance Commissioner of Louisiana and VP of the Natl. Assoc. of Ins. Commissioners, June 28, 2011.
28. Dodd-Frank Act §502.
29. Dodd-Frank Act §115.
30. Dodd-Frank Act §203(e)(3). For a discussion of this intriguing, and (one hopes) remote, possibility, *see* Don Mros and Richard Liskov, "Does 'Dodd-Frank' allow for federal liquidator of an insurance company?," *Financial Regulation International*, March 2011.

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