

## NAIC Approval of “Supervisory Colleges” Leaves Key Implementation Issues Unresolved

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Channeling their European counterparts, U.S. insurance regulators have adopted “supervisory colleges” as a new tool to regulate insurers and their affiliates. These bodies — working groups comprising the U.S. and non-U.S. regulators of an affiliated group of insurers — are intended to facilitate oversight of such companies at a group, rather than at an individual legal entity, level. Like other reforms adopted by the National Association of Insurance Commissioners (NAIC) in recent months, this technique is motivated by a new regulatory focus on “enterprise risk” in the wake of the 2008 financial crisis.

Implementing these colleges, however, is likely to present challenges and expose ambiguities in the NAIC’s prescribed framework for group supervision. Such obstacles may frustrate, rather than advance, U.S. policymakers’ goals of enhancing uniformity and efficiency. In addition, the state-based nature of U.S. insurance regulation itself may make supervisory colleges difficult to implement effectively, as discussed below. As the NAIC’s chief executive officer recently put it, “[s]upervisory colleges are certainly a start to greater collaboration in supervision, but . . . these have a long way to go.”<sup>1</sup>

### *Pursuing the “Group Supervision” Model, Post-2008*

Supervisory colleges are authorized under the NAIC’s December 2010 amendments to the model Insurance Holding Company System Regulatory Act (Model Act or Act), the model statute governing control over and acquisitions of insurance companies.<sup>2</sup> The individual states are currently awaiting guidance from the NAIC on exactly which provisions of the amended Act will be required to be adopted in order for states to maintain their NAIC accreditation.<sup>3</sup> The amendments make profound changes to the ways in which states are empowered to oversee the control of and affiliations with insurers located in the adopting state.

In particular, the amendments’ introduction of supervisory colleges, based on similar constructs in Basel II<sup>4</sup> and Solvency II<sup>5</sup> (Europe’s existing banking regime and its incipient insurance regime, respectively), has both a functional and a tactical goal for state regulators. Functionally, the NAIC is more focused than ever on group solvency. In the months following the 2008 crisis, the NAIC and state regulators averred that systemic risk regulation was

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no substitute for entity-level solvency regulation and that insurers as such had not played a role in the crisis.<sup>6</sup> At the same time, state insurance regulators had come to view themselves not only as policemen of individual insurance companies, but also as stewards of a highly interconnected financial system. As such, they began to embrace enterprise risk concepts as part of their overall regulatory vision.

In addition, state regulators and the NAIC seek preservation of the state-based insurance regulatory system itself. An effective system of supervisory colleges — with state insurance regulators working arm in arm with one another and with their counterparts in Europe and Asia — would vindicate claims that state regulation is effective and rigorous, rebutting those in industry and elsewhere that call for federal regulation of the insurance business.

The new Model Act says very little about the colleges themselves, leaving much of their contours and functions to practice.<sup>7</sup> Under the amendments, the state insurance commissioner is authorized to “participate in a supervisory college for any domestic insurer that is part of [an affiliated group] with international operations in order to determine compliance by the insurer with”<sup>8</sup> the state insurance code. A supervisory college may be established as a temporary or perpetual body and may include “other regulators charged with supervision of the insurer or its affiliates, including other state, federal and international regulatory agencies.”<sup>9</sup>

The Act goes on to say that the commissioner may participate in such a college “in order to assess the business strategy, financial position, legal and regulatory position, risk exposure, risk management and governance processes, and as part of [an] examination of [the insurer]”<sup>10</sup> and that the commissioner may enter into agreements providing for “the basis for cooperation between the commissioner and the other agencies and the activities”<sup>11</sup> of the college. The Model Act preserves all powers of the commissioner of the adopting state, specifying that “nothing in [the Act’s provisions on supervisory colleges]

shall delegate to the supervisory college the authority of the commissioner to regulate or supervise the insurer or its affiliates within its jurisdiction.”<sup>12</sup>

#### *Will Regulators Within a College Adopt a Uniform Approach — and Share Common Interests?*

Certain other provisions of the amended Act also advance the goal of policing enterprise risk, such as the Act’s grant of authority to the insurance commissioner to examine insurance-company affiliates.<sup>13</sup> (These provisions arguably go further than the previous version of the Act, which authorized an examination of affiliates only in a case where both (1) the regulator had ordered the insurer to produce copies of books and records that were “reasonably” necessary in order to determine compliance with laws and (2) the insurer had failed to comply with such order.)<sup>14</sup> The commissioner is also given the power to subpoena “any person” for purposes of determining compliance with the examination provision.<sup>15</sup> The potential interplay among these and other provisions raises a number of questions that could define the scope of Holding Company Act jurisdiction and practices for years to come.

#### *How would differing objectives within a college be reconciled?*

The supervisory college concept assumes that all regulators within the group seek the same goal of group solvency and stability. As far as the health of the group as a whole is concerned, this is sensible enough.

However, each regulator is likely to be primarily focused on the relevant market or sector in his or her country or state. In addition, entity-level risks and needs, on which regulators may not be aligned with one another within a group, cannot so easily be disaggregated from the condition of the whole.

Consider a hypothetical U.S.-based insurer owned by a Belgian entity primarily engaged in banking. A

supervisory college comprising the domiciliary state insurance commissioner and the Belgian bank regulator will generally have uniform goals in overseeing the group as a single enterprise. For instance, to the extent that a group-wide capital adequacy standard is in effect, the two regulators will be aligned in enforcing the standard insofar as the group capital metric, by definition, does not distinguish between constituent entities within the group and measures capital of the group as a whole. Thus, it could be expected that, on group capital requirements, the state regulator in our example would have no reason to assert a policy at odds with that of the Belgian bank regulator.

By the same token, on other matters, the regulators' interests may diverge. Take holding company liquidity, for example. The Belgian regulator will have an institutional interest in permitting greater dividends upstream from the insurer; the state insurance commissioner will tend to disfavor a permissive dividend regime because, under such a regime, it would be more difficult to keep capital within the insurer. In addition, each regulator may be able to justify his position by reference to enterprise risk, but considerations of enterprise risk will not necessarily provide a clear answer on any given question of inter-affiliate movement of value. Ultimately, the question of inter-affiliate dividends is a zero-sum game, illustrating the limitations of a "collegial" approach to regulation.

The easiest way to harmonize these differences would be to simply focus on the good of the holding company itself, disregarding questions of allocating resources within the group. This objective would align all participating regulators in the unified goal of holding company financial strength. But a moment's reflection will reveal that this merely begs the question of what the supervisory college exists to do — after all, regulating the entire group is something that typically the regulator of the top-tiered company is already empowered to do. Presumably, the college has a more refined mission, designed to safeguard financial strength at all regu-

lated levels of a holding company system. How regulators within colleges resolve these potential differences will play a significant role in shaping solvency regulation.

*What role would a supervisory college play in a Form A application?*

One of the principal functions of the Holding Company Act, both prior to and following the recent amendments, is to subject acquisitions of insurance companies to prior regulatory approval by means of a "Form A" filing.<sup>16</sup> A Form A filing is a detailed application, required to be submitted by the acquiror, containing information on the transaction, the acquiror's financial condition and management, and its plans for the future operations of the insurer. The supervisory colleges are not given an express role in the Form A process, but the mandate of such a college is, after all, to ensure compliance with the insurance law generally. It is not difficult to contemplate that a supervisory college, particularly one formed on a perpetual basis, would assert a role in a matter, such as an acquisition, being handled by one of its constituent regulators. This could alter the trajectory of Form A proceedings in significant ways.

For instance, consider the hypothetical U.S. insurer owned by the Belgian banking group. In the event that a third party reaches an agreement with the top-tiered Belgian entity to purchase the insurer for cash consideration, the insurer's domiciliary regulator must make a determination, on the basis of a Form A filed by the acquiror, that the acquisition satisfies the relevant criteria of the Holding Company Act — *e.g.*, that the acquiror's management possesses the requisite integrity and experience and that the insurer will be able to continue to satisfy its requirements for licensure. Although the Form A includes a requirement to disclose the nature and form of consideration, and regulators frequently request substantiation of purchase price determinations, the state regulator need not specifically consider the fairness of the consideration to the seller

or buyer. Indeed, where the acquisition is capital-neutral to the target insurer, and no leverage is involved in the deal, the actual amount of consideration should not affect policyholder protection or insurer solvency.

In a situation, however, where the domiciliary regulator belongs to a college, other college members would have interests distinct from those of the insurance commissioner and could seek to impose their own views on the acquisition. The Belgian regulator will likely find the adequacy of consideration being received by its entity to be a more compelling issue than will the domiciliary state regulator — after all, the Belgian entity is the one receiving the consideration and divesting a capital asset. Add to this the natural tendency of a body (in this case, the college) to self-perpetuate, as well as opportunities in Form A hearings for interested parties to seek intervenor status,<sup>17</sup> and the result could be an unintended complexity to Form A proceedings that may not necessarily serve policyholder interest.

*Will the new powers of a state insurance commissioner be subject to legal challenge?*

This likelihood of a college to focus on enterprise risks rather than policyholder interest, together with the state insurance commissioner's new subpoena powers as against holding companies and other insurer affiliates, may implicate U.S. legal principles that form the cornerstone of state insurance regulators' very powers.

Legal challenges have been periodically raised to the Holding Company Act based on the argument (among others) that insurance company control and affiliation matters are not properly considered the "business of insurance" within the meaning of McCarran-Ferguson, the federal statute that enshrines state regulation.<sup>18</sup> Courts have generally upheld the state laws, reasoning that laws designed to protect insurance company assets and property are sufficiently linked to policyholder protection.<sup>19</sup> To the extent, however, that these statutes (or the

regulators administering them) have purported to protect *stockholders* rather than policyholders, or these statutes have impeded the operation of federal securities laws, some courts have declared the Act invalid.<sup>20</sup> Can state legislators and regulators be confident that courts will uphold state regulators' ability to police "enterprise risk" (which necessarily affects constituencies beyond policyholders), as opposed to traditional policyholder protection or insurer solvency, particularly where such oversight would involve jurisdiction over out-of-state affiliates? The NAIC has gambled here that (1) existing U.S. caselaw, (2) interests of other countries, and (3) the renewed vigor that regulators enjoy generally as a result of the 2008 crisis will be sufficient to overcome any argument that the amended Act oversteps the boundaries imposed by McCarran-Ferguson.

As states adopt the amended Act, questions such as these will color its implementation and, indeed, the viability of state regulation of enterprise risk associated with local insurance companies.

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<sup>1</sup> Therese M. Vaughan, CEO, Nat'l Ass'n of Insurance Commissioners, Comments to the NAIC Solvency Modernization Initiative (SMI) Task Force Group: Supervision and the IAIS Common Framework for the Supervision of Internationally Active Insurance Groups (Com-Frame) 1 (Mar. 28, 2011), available at [http://www.naic.org/documents/education\\_schedule\\_holding\\_company\\_act\\_webinar.pdf](http://www.naic.org/documents/education_schedule_holding_company_act_webinar.pdf).

<sup>2</sup> *Model Laws, Regulations and Guidelines 440-1*, Insurance Holding Company System Regulatory Act (Nat'l Ass'n of Insurance Commissioners, 2010) [hereinafter

Model Act], available at [http://www.naic.org/documents/committees\\_models\\_table\\_of\\_contents.pdf](http://www.naic.org/documents/committees_models_table_of_contents.pdf).

<sup>3</sup> The NAIC is in the process of developing guidance on which provisions will be necessary for accreditation. In an early draft of such guidance, provisions regarding supervisory colleges were among the required provisions. See *Proposal for Substantially Similar Provisions of Revised Insurance Holding Company System Model Act (#440) and Regulation (#450)* (Nat'l Ass'n of Insurance Commissioners, Group Solvency Issues Working Group Draft, 2011).

<sup>4</sup> *International Convergence of Capital Measurement and Capital Standards ¶¶ 780-783* (Basel Committee on Bank Supervision, 2004), available at <http://www.bis.org/publ/bcbs107.pdf>.

<sup>5</sup> Directive 2009/138/EC of the European Parliament and of the Council of 25 November 2009 on the Taking-up and Pursuit of the Business of Insurance and Reinsurance (Solvency II), arts. 212-217, 2009 O.J. (L335).

<sup>6</sup> See, e.g., *Perspectives on Systemic Risk: Hearing Before the Subcomm. on Capital Markets, Insurance, and Government Sponsored Enterprises of the H. Comm. on Financial Services*, 111th Cong. (2009) (statement of Theres M. Vaughan, Ph.D., Chief Executive Officer, Nat'l Ass'n of Insurance Commissioners); *Perspectives on Modernizing Insurance Regulation: Hearing Before the S. Comm. on Banking, Housing and Urban Affairs*, 111th Cong. (2009) (statement of Michael T. McRaith, Director of Insurance, Illinois, on behalf of Nat'l Ass'n of Insurance Commissioners). On March 17, 2011, Treasury Secretary Geithner announced that Director McRaith would be appointed as the first director of the new Federal Insurance Office, established under the Dodd-Frank Wall Street Reform and Consumer Protection Act (Pub. L. 111-203).

<sup>7</sup> On March 18, 2011, the NAIC launched a web-based "International Supervisory Colleges Request Form" by which international regulators can request U.S. state regulator participation at supervisory colleges which they are convening. The form does not contain any substantive guidance on the nature or scope of such participation. See <https://eapps.naic.org/ISCR/index.do>.

<sup>8</sup> *Model Act* § 7A

<sup>9</sup> *Id.* at § 7C

<sup>10</sup> *Id.*

<sup>11</sup> *Id.*

<sup>12</sup> *Id.*

<sup>13</sup> *Id.* at § 6A

<sup>14</sup> *Model Laws, Regulations and Guidelines 440-1, Insurance Holding Company System Regulatory Act* (Nat'l Ass'n of Insurance Commissioners, 1993).

<sup>15</sup> *Model Act* § 6E

<sup>16</sup> *Id.* at § 3

<sup>17</sup> *Id.* at § 3(D)(2)

<sup>18</sup> 15 U.S.C. §§ 1011-1015

<sup>19</sup> See, e.g., *Holyake Investments Ltd. v. Gallinger*, 722 F. Supp. 573 (D. Ariz. 1989).

<sup>20</sup> See, e.g., *Gunter v. AGO International B.V.*, 533 F. Supp. 86 (N.D. Fla. 1981); *The News Corp. Ltd. v. Gunter*, 1984 U.S. Dist. LEXIS 24555 (N.D. Fla. 1984). Courts have struck down state anti-takeover laws outside the insurance context where such laws imposed unconstitutional burdens on interstate commerce, an area reserved to the federal government under the Constitution. See, e.g., *Edgar v. MITE Corp.*, 457 U.S. 624, 102 S. Ct. 2629 (1982); *Sharon Steel Corp. v. Whaland*, 466 A.2d 919 (N.H. 1983).