

Impact of Financial Regulatory Reform on the Insurance Industry:  
Proposed Legislation to Implement the Administration's Regulatory Reform  
White Paper

By

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At the end of July, 2009 the Obama Administration sent draft legislative proposals to Capitol Hill that could have a significant impact on the insurance industry.<sup>1</sup> One set of broad legislative proposals dealt with measure to modernize the financial regulatory system; a second set dealt with the regulation of the derivatives market. This paper addresses how both sets of legislative proposals may affect the insurance industry.

## Part I: The Administration's Draft Legislation to Modernize the Financial Regulatory System

The Administration's draft legislation on modernizing the financial regulatory system is intended to implement the proposals from the Treasury White Paper on financial regulatory reform.<sup>2</sup> In particular, the draft legislation calls for: (1) the designation of the Board of Governors of the Federal Reserve System (the Fed) as the systemic regulator with broad authority over all financial firms, including insurers; (2) the creation of an Office of National Insurance (ONI); (3) the creation of the Financial Services Oversight Council (the Council); and (4) a variety of amendments to existing legislation that would render any insurance company complex that also owns a depository institution a financial holding company subject to regulation by the Fed.

The precise timing and trajectory of financial regulatory reform remain uncertain. House Financial Services Committee Chair Barney Frank (D-Mass.), in a speech to the National Press Club on July 29, 2009, reiterated his plan to move forward with financial reform legislation this fall and predicted a bill would be signed into law by the President by the end of this year. However, there is some question whether there will be sufficient time for the Senate to act on financial reform legislation this year.<sup>3</sup>

This section of the paper provides an overview of the following aspects of the Administration's proposed legislation as well as the implications for the insurance industry:

(1) Systemic Risk Regulation by the Fed; (2) the creation and operation of the ONI; (3) the creation and operation of the Council; (4) enhanced resolution authority for systemically important institutions; and (5) a variety of amendments to banking laws that (a) result in a single Federal banking charter and Federal functional banking regulator, and (b) impact the manner in which all holding companies owning depository institutions are regulated.

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<sup>1</sup> The author wishes to thank her colleagues, Eric A. Arnold, Stephen E. Roth and James M. Cain, for their assistance with this paper.

<sup>2</sup> See SUTHERLAND LEGAL ALERT "Financial Regulatory Reform – A New Foundation: Building Financial Supervision and Regulation" at [www.sutherland.com/alertspubs/](http://www.sutherland.com/alertspubs/) (June 19, 2009). The U.S. Department of the Treasury (Treasury) has released proposed legislation in a piecemeal fashion since the end of June to implement the directives of the Treasury White Paper. This paper focuses on those proposals that were released in late July that have a significant impact on insurers. A comprehensive list of all the proposed legislation released to date, and the Treasury's "fact sheets" on such legislation, is available at: <http://www.ustreas.gov/initiatives/regulatoryreform/>.

<sup>3</sup> While there have been a number of reform proposals introduced by Congress so far this year, or sent to Capitol Hill by the Treasury, we should also note that Rep. Spencer Bachus (R-Ala.) (the ranking member of the House Financial Services Committee) and other House Republicans have introduced their own version of regulatory reform legislation, the Consumer Protection and Regulatory Enhancement Act, H.R. 3310, on July 23, 2009. This is relatively broad legislation that, among other things, amends the bankruptcy code for handling insolvencies of large non-bank financial institutions, establishes a Market Stability and Capital Adequacy Board to identify risks to the financial system, creates a new body—the Financial Institutions Regulator—to act as the umbrella regulator for all depository institutions, phases out government support for government sponsored enterprises, eliminates the Federal regulators' reliance on credit rating firms, and limits the Fed's supervisory and regulatory powers and requires the Fed to focus on monetary policy, including setting an explicit inflation target. The bill has 27 co-sponsors. It remains to be seen to what extent the ideas and concepts in H.R. 3310 will be incorporated into the legislation that the Democrats eventually move through the Congress.

## Possible Implications for Insurance Industry of Financial Modernization Proposals – Executive Summary

Key provisions of the financial modernization proposals raise the following issues for insurance companies and their holding companies:

- Since an insurance company would be engaged in activities that are financial in nature, it, or its holding company depending on the organization's corporate structure, could be designated as a Tier 1 Financial Holding Company (FHC) by the Fed regardless of whether or not the organization owns a depository institution;
- Any insurance holding company or insurer that owns any type of depository institution (e.g., Federal savings bank, limited purpose national banks engaging in trust-only activities, certain State-chartered trust companies, credit card banks, industrial loan companies) will become a financial holding company subject to regulation by the Fed;<sup>4</sup>
- The Fed may prescribe prudential regulations for an insurance company that is designated as a Tier 1 FHC that might conflict with, and likely be more onerous than, those imposed under State insurance laws;
- Functionally regulated subsidiaries of a Tier 1 FHC (e.g., an insurance company) may be subject to enforcement actions by the Fed that could include civil money penalties and removal of officers and directors, without coordination with State insurance regulators or the ONI;
- By granting the Secretary of the Treasury the power to negotiate and enter into certain international agreements on prudential matters related to insurance, and granting the ONI the authority to preempt inconsistent State law provisions, insurers may be faced with conflicting mandates on prudential matters and may need to focus attention on solvency and other risk management initiatives at both the State and Federal levels;
- The Council does not include any representation of the insurance industry as there is no seat at the table for any State insurance regulator, the National Association of Insurance Commissioners (NAIC), or even the ONI.

### A. Systemic Risk Regulation Under the Federal Reserve<sup>5</sup>

As anticipated, the proposed legislation calls on the Fed to serve as the systemic risk regulator under the Bank Holding Company Modernization Act of 2009 (BHC Modernization Act). The BHC Modernization Act would grant the Fed the power to: (1) designate any U.S. company or any foreign company engaged in activities that are "financial in nature" and that it determines to be of systemic importance as a Tier 1 FHC; and (2) impose standards on and supervise Tier 1 FHCs and their affiliates. The BHC Modernization Act also provides for the interaction of, and shared oversight where applicable between and among, the Fed and the Council (described below), the Treasury, other Federal regulators, and in some cases, State regulators.

**Designation of Tier 1 FHCs.** The proposed BHC Modernization Act would grant the Fed the authority to designate any "United States Financial Company" or "Foreign Financial Company" as a Tier 1 FHC. To be deemed a "United States Financial Company," the company must be "in whole or in part engaged in,

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<sup>4</sup> We note that the Tier 1 FHC proposals identified herein in many respects provide for expanded, and almost individualized, Fed regulation as compared to the current Fed regulation of a financial holding company or a bank holding company.

<sup>5</sup> See Title II – Consolidated Supervision and Regulation of Large, Interconnected Financial Firms, available at: <http://www.financialstability.gov/docs/regulatoryreform/07222009/titleII.pdf>.

directly or indirectly, activities in the United States that are financial in nature.”<sup>6</sup> A Foreign Financial Company could fall under the new regulatory regime if the foreign company, by itself or through a branch in the United States, engages in activities that are financial in nature.

The Fed may designate a Tier 1 FHC<sup>7</sup> by regulation or order, and such designations must be reevaluated by the Fed at least annually. The BHC Modernization Act would provide for an appeal process from both a designation as a Tier 1 FHC and a rescission of such status. In addition, there are emergency/expedited exception procedures to the hearing process that can be put into place upon the vote of a specified number of members of the Board of the Fed.

In general, a designation as a Tier 1 FHC would be triggered by the Fed’s determination that “material financial distress at the company could pose a threat to global or United States financial stability or the global or United States economy during times of economic stress.” The Fed is expressly directed to consider the following criteria in making a determination as to whether an institution is a Tier 1 FHC:

- The amount and nature of the company’s assets;
- The amount and type of liabilities, including reliance on short-term funding;
- The company’s off-balance sheet exposure;
- The degree of interconnectedness in terms of the extent of the company’s transactions and relationships with other major financial companies;
- The importance of the company as a source of credit and liquidity;
- The recommendations of the Council; and
- Other factors the Fed deems appropriate.

If the purported Tier 1 FHC has functionally regulated subsidiaries, then the Fed would be obligated to consult with the primary Federal regulatory agency for such regulated subsidiary before making any designation, or rescinding any designation, as a Tier 1 FHC. The Fed must promulgate regulations with respect to the criteria for designation of Tier 1 FHCs, and must do so in consultation with the Secretary of the Treasury and the Council.

The Fed can require certain U.S. and Foreign Financial Companies to submit information “for the sole purpose of determining whether to designate the company as a” Tier 1 FHC. The following three financial standards are benchmarks<sup>8</sup> for the Fed to use in identifying which companies may have to provide information:

- \$10 billion or more in assets;
- \$100 billion or more in assets under management; or
- \$2 billion or more in gross annual revenue.

A Foreign Financial Company that has comparable financial figures derived from U.S. sources may also be required to submit such information.

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<sup>6</sup> Insurance underwriting and insurance agency activities are “financial in nature” under other provisions of the Bank Holding Company Act (BHC Act). See 12 U.S.C. 1843(k)(4)(B) *Activities that are financial in nature*:

(B) Insuring, guaranteeing, or indemnifying against loss, harm, damage, illness, disability, or death, or providing and issuing annuities, and acting as principal, agent, or broker for purposes of the foregoing, in any State.

<sup>7</sup> We use the term “Tier 1 FHC” to refer to both United States and Foreign Tier 1 FHCs, unless otherwise indicated.

<sup>8</sup> The financial benchmarks are based on the amounts declared in the company’s most recent financial statements.

These figures are surprisingly modest, if they are intended to indicate the size of the firms that might be deemed to be Tier 1 FHCs. The Fed is not required to consider any particular dollar amounts or ranges when making its determination as to whether an institution is a Tier 1 FHC; there is no minimum size requirement for a Tier 1 FHC.

### *Possible Implications for the Insurance Industry*

- Since a Tier 1 FHC is not required to own or control any type of depository institution but merely must be engaged in activities that are “financial in nature,” such as insurance, an insurance holding company could be designated as a Tier 1 FHC regardless of whether it owns a bank or other depository institution.
- It appears that there is no requirement that the Fed consult with State insurance regulators in its determination on whether an insurance company complex should be deemed a Tier 1 FHC, since the requirement for the Fed to discuss such a determination for each functionally regulated subsidiary is limited to the primary Federal regulatory agency of such subsidiary.
- The Fed is required to consult with the Council and the Treasury Secretary in promulgating regulations on the criteria for determining Tier 1 FHCs, but is not required to consult with State insurance regulators. Moreover, the Council does not include any State insurance regulators or representatives of the ONI.
- Any insurer that meets the relatively modest financial requirements outlined above could be subject to an information request from the Fed, regardless of whether or not such insurer owns a depository institution.

**Impact of Designation as a Tier 1 FHC.** Once a company is designated as a Tier 1 FHC, it must:

- Register with the Fed;
- Comply with all prudential standards (e.g., risk-based capital) set by the Fed;
- Submit reports to the Fed and disclose certain information to the public;
- Be subject to examinations and enforcement by the Fed;
- Subject its functionally regulated subsidiaries to certain types of exceptional prudential regulation;
- Conform its activities to the requirements applicable to financial holding companies;
- Be subject to limits on its acquisition activity; and
- Be subject to significant regulatory limitations through a “prompt corrective action” regime.

**Registration:** Each Tier 1 FHC must register with the Fed as a Tier 1 FHC, on forms designated by the Fed, within 180 days of the designation of such company as a Tier 1 FHC.

**Prudential Standards:** Any company designated as a Tier 1 FHC must comply with a myriad of prudential standards. These standards are required to be “more stringent than the standards applicable to bank holding companies to reflect the potential risk posed to financial stability.” The Fed is required to consult with the Council on regulations or guidance on prudential standards that will include, but not be limited to:

- Risk-based capital requirements;
- Leverage limits;
- Liquidity requirements; and
- Overall risk management requirements.

The Fed may prescribe different standards for different Tier 1 FHCs, taking into consideration their risk, complexity and financial activities. In all cases, however, a Tier 1 FHC must, at all times, be well capitalized and well managed.

**Reports:** The Fed can require each Tier 1 FHC and any of its subsidiaries to provide reports on: (1) its financial condition; (2) its systems for monitoring and controlling financial, operational and other risks; (3) its transactions with any depository institution subsidiaries; and (4) the extent to which its and its subsidiaries' operations pose a threat to financial stability.

In addition, the Fed must require each U.S. Tier 1 FHC to report periodically to the Fed on:

- Its plan for “rapid and orderly” resolution in the event of severe financial distress;
- The nature and extent to which the Tier 1 FHC has credit exposure to other Tier 1 FHCs; and
- The nature and extent to which other Tier 1 FHCs have credit exposure to the Tier 1 FHC.<sup>9</sup>

The Fed is required, “to the fullest extent possible,” to use reports that the Tier 1 FHC or its functionally regulated subsidiaries provide to other Federal or State regulatory agencies to satisfy these requirements. In addition, the Fed is directed to collect this information from public reports or externally audited financial statements.

### *Possible Implications for the Insurance Industry*

- The Fed may prescribe prudential standards for an insurance company that is a Tier 1 FHC that may be different from those required by State insurance law or by the prudential regulator in the country where the Foreign Tier 1 FHC is incorporated, raising the question of whether the Fed's prudential standards would preempt State insurance or foreign prudential standards.
- The Fed can compel any Tier 1 FHC, or any subsidiary of a Tier 1 FHC, including any insurance company, to submit reports, although the Fed is required to use reports provided to other agencies, including State regulatory agencies, to satisfy the requirements.

**Examinations and Enforcement:** Under the proposed BHC Modernization Act, the Fed would be granted the authority to examine each U.S. Tier 1 FHC and each of its subsidiaries, and any U.S. subsidiaries, branches or agencies of a Foreign Tier 1 FHC. As is the case with the reports described above, to the extent possible, the Fed shall rely on reports of examinations of U.S. Tier 1 FHCs and their functionally regulated subsidiaries made by other Federal or State regulators.

The proposed legislation also grants back-up examination authority to the Federal Deposit Insurance Corporation (FDIC) to access any of the Fed's examination reports and to recommend to the Fed that a Tier 1 FHC or any of its subsidiaries be examined.<sup>10</sup> In the event that the Fed does not initiate an examination after a request from the FDIC, the FDIC can initiate its own examination.<sup>11</sup>

From an enforcement perspective, the Fed will have all the tools currently available under the Federal Deposit Insurance Act (e.g., cease-and-desist orders, civil money penalties, suspension and removal of officers and directors) to use against a Tier 1 FHC *and its non-bank subsidiaries*. The BHC Modernization Act defers to “the primary Federal regulatory agency” in actions against a functionally regulated subsidiary, and may direct such agency to take action in writing. If such agency does not take action within 30 days, the Fed can initiate the action.

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<sup>9</sup> See § 204 of Title II, which adds § 6(d)(1)(B) to the BHC Act. Newly proposed § 6B to the BHC Act grants the Fed the authority to prohibit any Tier 1 FHC from having credit exposure to any unaffiliated company that exceeds 25% of the Tier 1 FHC's capital stock and surplus, or any lower amount that the Fed determines is necessary to mitigate risks.

<sup>10</sup> See § 204 of Title II, which adds § 6(d)(3) to the BHC Act.

<sup>11</sup> See § 204 of Title II, which adds § 6(d)(3)(B)(ii) to the BHC Act.

### *Possible Implications for the Insurance Industry*

- Insurance companies that are Tier 1 FHCs, or are subsidiaries of Tier 1 FHCs, would be subject to examinations by the Fed, and by the FDIC under its potential “back-up” examination authority.
- Insurance companies that are Tier 1 FHCs, or are subsidiaries of Tier 1 FHCs, would be subject to the significant enforcement structure under the Federal Deposit Insurance Act.
- While the BHC Modernization Act would require that the Fed act through the “primary Federal regulatory agency” for enforcement actions against a functionally regulated subsidiary, there does not appear to be any role for State insurance regulatory authorities under this regime. Thus, it appears that State-regulated insurance companies would be subject to *direct* action by the Fed.

**“Exceptional” Regulations Imposed on Functionally Regulated Subsidiaries:** The Fed is granted potentially broad authority to prescribe orders, impose regulations, examine or bring enforcement actions against a functionally regulated subsidiary of a Tier 1 FHC if the subsidiary poses a risk to financial stability. In addition, the Fed has the power to “enforce more stringent prudential standards” on such a subsidiary. The Fed must consult with the Council and with “the appropriate Federal regulatory agencies” for the subsidiary before it takes action with respect to the subsidiary.

Prior to acting, the Fed must also have reasonable cause to believe that the functionally regulated subsidiary is engaged in conduct that could pose a threat to the global or U.S. economy or financial stability. In addition, the Fed must notify the appropriate Federal regulatory agency in writing with a recommendation that such agency take specified actions, and if such agency has *not* notified the Fed within 30 days that such agency has taken the specified actions, then the Fed may take action.

### *Possible Implications for the Insurance Industry*

- It does not appear that State insurance regulators need to be consulted prior to the imposition of “exceptional” prudential standards since the Fed is required to act through the “appropriate Federal regulatory agency.”

**Transition Issues – Non-Conforming Assets:** Once identified as a Tier 1 FHC, the activities of such an organization must, within 5 years, be conformed to those permissible for a financial holding company. In general, therefore, any non-financial activities of the Tier 1 FHC would need to be divested. In addition, a Tier 1 FHC is required to conduct all of its activities that are “financial in nature” through a single, intermediate holding company during a 5-year phase-in period, and such intermediate holding company must be established no later than 90 days after the designation as a Tier 1 FHC.

### *Possible Implications for the Insurance Industry*

- Designation as a Tier 1 FHC could have immediate implications for the corporate structure of an existing insurance holding company by requiring an intermediate holding company to be formed that would own all of the businesses whose activities are “financial in nature.” If none of such holding companies are outside the scope of the term “financial in nature,” then restructuring may be avoided.

**Acquisitions:** With respect to bank acquisitions, a Tier 1 FHC would be treated as if it were a bank holding company under the BHC Act and subjected to the same approval process. With respect to non-

bank acquisitions, there are a number of limitations. Any “large” acquisition of a non-banking company<sup>12</sup> is subject to a notice filing to the Fed in advance of such acquisition. In general, the standard review procedures for review of a bank holding company acquisition would apply, although the Fed must deny any acquisition if the Tier 1 FHC is not, both before and immediately after the acquisition, well capitalized and well managed.

**Prompt Corrective Action:** Tier 1 FHCs would be subject to a prompt corrective action regime that would require the firm and its primary Federal regulatory agency to take corrective actions as the firm’s regulatory capital levels decline.<sup>13</sup> This regime is intended to mirror the prompt corrective action regime for insured depository institutions established under the Federal Deposit Insurance Corporation Improvements Act of 1991. If the Tier 1 FHC is not “well capitalized,” it falls into the category of being “undercapitalized” and it is subject to a panoply of requirements.<sup>14</sup> Undercapitalized Tier FHCs would be subject to the following:

- Most capital distributions could be restricted;
- The Tier 1 FHC would be subject to Fed monitoring;
- A capital restoration plan would be required;
- The Tier 1 FHC would be subject to asset growth restrictions; and
- Prior approvals would generally be required for acquisitions or new lines of business.

In addition, undercapitalized Tier 1 FHCs may be subject to the following:<sup>15</sup> (1) a requirement to raise additional capital; (2) restrictions on transactions among affiliates; (3) stricter asset growth limits; (4) a requirement that the Tier 1 FHC or any of its subsidiaries alter, reduce or terminate any activity that the Fed determines poses excessive risk to the Tier 1 FHC; (5) a requirement to elect and/or appoint new management; (6) a required divestiture or liquidation of any subsidiary if the Fed determines it is “in danger of becoming insolvent, poses a significant risk to the Tier 1 [FHC], or is likely to cause a significant dissipation of” assets or earnings;<sup>16</sup> and (7) limitations on bonuses and senior management compensation.

### *Possible Implications for the Insurance Industry*

- An insurance holding company complex that is deemed to be a Tier 1 FHC and that becomes undercapitalized would become subject to significant and pervasive oversight and, in effect, management, by the Fed.
- An insurance company subsidiary of a Tier 1 FHC could be compelled to terminate an activity (e.g., the offering of a particular type of product or rider to a product) if the Fed determines that it poses excessive risk to the Tier 1 FHC.
- The Fed could, in certain circumstance, compel a Tier FHC to divest or liquidate an insurance company subsidiary.<sup>17</sup>

<sup>12</sup> The standard under the BHC Modernization Act is “total consolidated assets of \$10 billion or greater.”

<sup>13</sup> See § 204 of Title II, which adds § 6A to the BHC Act.

<sup>14</sup> Bank holding companies and financial holding companies that are not Tier 1 FHCs have an additional capital category, “adequately capitalized,” which affords different treatment.

<sup>15</sup> For a Tier 1 FHC that is “significantly undercapitalized,” these would be mandatory restrictions and requirements.

<sup>16</sup> We note that the Fed is required to consult with “the appropriate regulator” of such subsidiary if such subsidiary is subject to any financial responsibility or capital requirements.

<sup>17</sup> It is unclear how insurance company insolvency provisions may play out in this context.

## B. Office of National Insurance<sup>18</sup>

Consistent with the Treasury's White Paper and with H.R. 2609 (a bill introduced by Rep. Paul Kanjorski in May 2009 to create an Office of Insurance Information), Title V of the new legislative proposals titled the "Office of National Insurance Act of 2009" (ONI Act) calls for the establishment of the Office of National Insurance (the ONI) in Treasury. The ONI would be headed by a Director, who would be appointed by the Secretary of the Treasury, and the position would not be subject to Senate confirmation.

The ONI's role would consist primarily of gathering information about the U.S. insurance industry, monitoring the industry for systemic risk and consulting with State regulators, although it would be given significant power on the international front. In particular, the ONI would be empowered to establish Federal policy on the prudential aspects of international insurance matters, assist in negotiating any International Insurance Agreements on Prudential Measures (International Insurance Agreements),<sup>19</sup> and determine whether a particular State insurance measure is preempted by prudential measures in an International Insurance Agreement. In addition, the Secretary of the Treasury would be authorized to negotiate and enter into International Insurance Agreements on behalf of the United States.

More specifically, the ONI would have the authority, under the direction of the Secretary of the Treasury, to:

- **Monitor** all aspects of the insurance industry, including identifying issues or gaps in the regulation of insurers that could contribute to a systemic crisis in the insurance industry or the U.S. financial system;
- **Recommend** to the Fed that it designate an insurer, including its affiliates, as an entity subject to regulation as a Tier 1 FHC;<sup>20</sup>
- **Establish** and coordinate Federal policy on prudential aspects of international insurance matters, including representing the United States in the International Association of Insurance Supervisors and assisting the Secretary of the Treasury in negotiating International Insurance Agreements;
- **Determine**, after publication of notice and opportunity for comment, that a State insurance measure<sup>21</sup> is preempted by International Insurance Agreements to the extent that the measure: (1) directly or indirectly treats a non-U.S. insurer domiciled in a foreign jurisdiction that is subject to an International Insurance Agreement less favorably than it treats a U.S. insurer domiciled or admitted in that State, and (2) is inconsistent with an International Insurance Agreement; and
- **Consult** with the States regarding insurance matters of national importance and prudential insurance matters of international importance.

The ONI would be empowered to collect a broad range of information on and from the insurance industry, insurers and their affiliates, to enter into information-sharing agreements, to analyze and disseminate data and information, and to issue reports on all lines of insurance, except health insurance. In collecting data, the ONI must coordinate with each relevant State insurance regulator to determine if the information

<sup>18</sup> Title V – Office of National Insurance, available at:

<http://www.financialstability.gov/docs/regulatoryreform/07222009/title%20V%20Ofc%20Nat%20Ins%207-22-2009%20fnl.pdf>.

<sup>19</sup> "International Insurance Agreement on Prudential Measures" is defined as a written bilateral or multilateral agreement entered into between the United States and a foreign government, authority, or regulatory entity regarding prudential measures applicable to the business of insurance or reinsurance. The term "prudential measures" is not defined, but presumably would include standards regarding risk-based capital requirements, leverage limits, liquidity requirements and overall risk management requirements.

<sup>20</sup> We note that the BHC Modernization Act does not appear to have a corresponding reference.

<sup>21</sup> "State insurance measure" is defined as any State law, regulation, administrative ruling, bulletin, guideline, or practice relating to or affecting prudential measures applicable to insurance or reinsurance.

is available from the regulator, and the proposal specifically authorizes each such State regulator or other Federal regulator to provide information and data to the ONI. The ONI Act also explicitly states that the submission of any non-public information or data to the ONI “shall not constitute a waiver of, or affect, any privilege” arising out of law or the rules of a court. The ONI would also have the power to require, by subpoena signed by the Director of the ONI, the production of data or information requests, and to have the subpoena enforced by an order of any appropriate U.S. district court.

The ONI Act would not preempt any State insurance measure that governs any insurer’s rates, premiums, underwriting or sales practices, and that it should not be construed to alter, limit or amend any provision of the Consumer Financial Protection Agency Act of 2009. Finally, the Director of the ONI would be required to submit an annual report to the President and to Congress on any preemptive action it took, and on any other information deemed relevant by the Director.

### *Possible Implications for the Insurance Industry*

- The sweeping powers of the ONI to collect and analyze data on insurers and their affiliates would, for the first time, give the Federal government the analytic tools it needs to critically assess the adequacy and effectiveness of State insurance prudential measures.<sup>22</sup>
- The information-gathering and analysis potential of the ONI would require insurers and their affiliates to consider how information currently provided to the States on capital, surplus, reserves, liquidity and risk management might be interpreted by the ONI.
- The information-gathering and analysis potential of the ONI could have a major impact on the Federal regulation of the insurance industry, as it would form the basis of any recommendations made to the Fed to have an insurer, and its affiliates, designated as a Tier 1 FHC, and may be used in conjunction with the efforts of the Fed and the Council under the BHC Modernization Act.
- By granting the Secretary of the Treasury the power to negotiate and enter into International Insurance Agreements, while granting the ONI the power to preempt inconsistent State provisions, the ONI Act would cause insurers to pay close attention to the ways that international agreements could impact their solvency and risk management measures.

### **C. Establishing a Financial Services Oversight Council<sup>23</sup>**

The proposed legislation would also establish the Council under the Financial Services Oversight Council Act of 2009. The Council will have the following eight members:

1. The Secretary of the Treasury (serving as the chairman);
2. The Chairman of the Board of Governors of the Federal Reserve System;
3. The Comptroller of the Currency and the Director of the Office of Thrift Supervision until their functions are transferred to the newly proposed position of a National Bank Supervisor, at which time the National Bank Supervisor will be the member;
4. The Director of the Consumer Financial Protection Agency;
5. The Chairman of the Securities and Exchange Commission;
6. The Chairman of the Commodity Futures Trading Commission;

<sup>22</sup> At a hearing of the Senate Banking Committee held July 28, 2009, on “Regulatory Modernization: Perspectives on Insurance,” discussion focused on whether the ONI went far enough in unifying prudential regulation for insurance companies. Chairman Dodd indicated that he was convinced that the ONI should move forward, but agreed that the Committee should continue to examine whether the scope of powers of the ONI should be expanded.

<sup>23</sup> See Title I – Financial Services Oversight Council, available at: <http://www.financialstability.gov/docs/regulatoryreform/07222009/titleI.pdf>.

7. The Chairperson of the FDIC; and
8. The Director of the Federal Housing Finance Agency.

The Council's role is generally threefold: (1) to advise Congress and the Fed on matters of financial regulation; (2) to recommend to the Fed which firms should be designated as systemically important financial institutions; and (3) to monitor the financial services marketplace and facilitate information sharing and coordination among the financial regulators regarding regulatory issues. The legislation does not contemplate that the Council would have broad powers (e.g., enforcement) outside of those identified above.<sup>24</sup>

Under the proposed legislation, the Council shall:

- Advise Congress on financial regulation and make recommendations to enhance, among other things, the stability of the financial markets and investor confidence;
- Monitor the financial services marketplace for threats to stability;
- Advise the Fed on the designation of Tier 1 FHCs; and
- Provide a forum for discussion.<sup>25</sup>

The Council will be authorized to receive information collected by the Fed with respect to its duties to identify and designate possible Tier 1 FHCs. In addition, the Fed *must* consult with the Council prior to prescribing rules and prudential standards on Tier 1 FHCs, as described above. The Council could also appoint special advisory committees, the members of which could be any persons the Council desires.

### *Possible Implications for the Insurance Industry*

- The insurance industry would have no representation on the Council as there is no role on the Council for any State insurance regulator, the NAIC, or even the Director of the ONI.<sup>26</sup>
- The Council could, however, appoint a special advisory committee on the insurance industry, in which case it may include State insurance regulators if the Council desires.
- The Council could receive information about insurance companies and their affiliates from the Fed and/or the ONI under the proposed legislation.

### **D. Enhanced Resolution Authority<sup>27</sup>**

This is the second version of proposed legislation<sup>28</sup> that gives the Federal government so-called resolution authority pursuant to which the government can dissolve large, interconnected firms when the

<sup>24</sup> In their testimony before the Senate Banking Committee on July 23, 2009 on "Establishing a Framework for Systemic Risk Regulation," both FDIC Chairman Sheila Bair and SEC Chairman Mary Schapiro urged Congress to give the Council more power, including the ability to overrule other regulators when they fail to act and to establish rules for capital and liquidity standards for systemically important institutions. It is unclear how this more powerful Council would be reconciled with the Fed's role or the primary systemic risk regulator. Chairman Bair re-stated these views to the Senate Banking Committee on August 4, 2009 in a hearing on "Strengthening and Streamlining Prudential Bank Supervision."

<sup>25</sup> The Council is required to meet at least quarterly.

<sup>26</sup> The incongruity of the lack of insurance regulatory representation was identified by Baird Webel, Specialist in Financial Economics, Congressional Research Service, during his July 28, 2009, testimony at the Senate Banking Committee's hearing on Regulatory Modernization: Perspectives on Insurance.

<sup>27</sup> See Title XII – Enhanced Resolution Authority, available at: [http://www.financialstability.gov/docs/regulatoryreform/title-XII\\_resolution-authority\\_072309.pdf](http://www.financialstability.gov/docs/regulatoryreform/title-XII_resolution-authority_072309.pdf).

<sup>28</sup> We note that two members of the Senate Banking Committee, Mark Warner (D-Va.) and Bob Corker (R-Tenn.), introduced S. 1540, which provides for additional resolution authority to the FDIC to resolve a bank holding company if the federally insured bank owned by the holding company fails.

stability of the financial system is threatened. The new version is very similar to the proposed legislation released in March, 2009.<sup>29</sup>

The proposals for the resolution authority are modeled after the resolution authority that the FDIC currently has with respect to banking institutions, and are generally intended to supplement (rather than replace) bankruptcy laws. The current proposal, however, applies to a smaller range of companies, i.e., it covers: (1) bank holding companies; (2) all Tier 1 FHCs; and (3) any subsidiary of the above but excludes subsidiaries that are *insurance companies* or insured depository institutions or registered broker-dealers that are Securities Investor Protection Corporation members.<sup>30</sup>

The resolution authority could be invoked only upon the successful recommendation of at least a two-thirds vote by the Fed and a two-thirds vote by the directors of the FDIC or the commissioners of the Securities and Exchange Commission, as the case may be, *and* upon the approval of the Secretary of the Treasury.<sup>31</sup> The proposal would give Treasury the ability to appoint the FDIC or the SEC as conservator or receiver for a failing financial firm that poses a threat to the financial stability of the system in cases where a resolution would avoid or mitigate the adverse effects.<sup>32</sup> The conservator or receiver of the firm will have a broad set of powers including the authority to act as a successor to the failing financial firm and to take full control of the operations of the firm.<sup>33</sup> The resolution authority also provides for less drastic measures, which include the ability to provide loans, assume liabilities, guarantee obligations, acquire equity interests or assets, or sell or transfer any assets, liabilities, obligations, equity interests or securities of the firm and/or the subsidiary that was determined to be in need of assistance or action.<sup>34</sup>

#### *Possible Implications for the Insurance Industry*

- Insurance companies or holding companies of insurance companies that themselves are designated as Tier 1 FHCs would be subject to the new resolution authority of the Fed.

#### **E. Creation of a New National Bank Supervisor<sup>35</sup>**

The Treasury's proposed legislation creates a National Bank Supervisor (NBS) through the consolidation of the Office of Thrift Supervision (OTS) and the Office of the Comptroller of the Currency (OCC) under the Federal Depository Institutions Supervision and Regulation Improvements Act of 2009. The NBS would assume all of the functions and responsibilities of the OCC and the OTS. This consolidation will also eliminate the Federal thrift charter and thrift holding company framework.<sup>36</sup> The consolidation is intended to address issues of regulatory arbitrage in the Federal bank regulatory system.

<sup>29</sup> A copy of the March, 2009, proposal on resolution authority can be found at: <http://www.treas.gov/press/releases/reports/032509%20legislation.pdf>.

<sup>30</sup> See § 1202(2) of Title XII.

<sup>31</sup> See § 1203(a)-(b).

<sup>32</sup> See §§ 1204(b) and 1203(b).

<sup>33</sup> See § 1209(a) for powers and authority bestowed on the conservator or the receiver.

<sup>34</sup> See § 1204(a).

<sup>35</sup> See Title III – Improvement to Supervision and Regulation of Federal Deposit Institutions, available at: [http://www.financialstability.gov/docs/regulatoryreform/title-III\\_Natl-Bank-Supervisor\\_072309.pdf](http://www.financialstability.gov/docs/regulatoryreform/title-III_Natl-Bank-Supervisor_072309.pdf).

<sup>36</sup> See § 351(a) of Title III, which requires that within 6 months of the enactment of the legislation, each savings association must elect to be either national bank, mutual national bank, State bank or State savings association.

### *Possible Implications for the Insurance Industry*

- If an insurance company complex includes a Federally chartered thrift institution, such institution would need to be converted into either: a national bank or mutual national bank, regulated by the NBS; a State savings association (regulated by the FDIC);<sup>37</sup> or a State-member bank (regulated by the Fed).
- After such a conversion, any insurance company complex would be subject to regulation as a financial holding company by the Fed.

### **F. Holding Company Status<sup>38</sup>**

Under the Administration's proposal all companies that control an insured depository institution would be subject to consolidated supervision and regulation at the Federal level by the Fed and will be subject to the non-financial activity limits contained in the BHC Act. The BHC Act would be amended to require the registration as a bank holding company of any company controlling an insured depository institution.<sup>39</sup> Any holding company that owns a thrift would no longer be regulated separately as a savings and loan holding company. The proposal also amends the BHC Act with respect to the conditions required to allow a bank holding company to engage in activities that are financial in nature.<sup>40</sup> Under these provisions, to engage in such activities, there is a new requirement that the bank holding company be well capitalized and well managed.

The Fed would have the authority to grant temporary exemptions or provide other appropriate temporary relief to permit affected companies to implement measures necessary to comply with the restrictions on activities imposed on bank holding companies.<sup>41</sup> The limited exemptions and grace period for existing non-financial activities may pose significant challenges for grandfathered unitary savings and loan holding companies and commercial companies that own industrial loan companies or credit card banks.

### *Possible Implications for the Insurance Industry*

- Insurance holding companies and insurance companies that own depository institutions (including Federal savings institutions, limited purpose national banks, industrial loan companies, credit card banks, certain trust companies) would be regulated by the Fed and be required to register with the Fed as financial holding companies.
- Financial holding companies face more restrictions than thrift holding companies regarding the type of permissible activities and the type of transactions with affiliates.
- Any insurance holding company and any insurer that is a financial holding company must be well capitalized and well managed.

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<sup>37</sup> The supervision of State savings associations will be transferred to the FDIC. See § 321(b)(3). The supervision of national banks and mutual national banks will be transferred to the NBS. See § 321(a).

<sup>38</sup> See Title VI – Further Improvements to the Regulation of Bank Holding Companies and Depository Institutions, available at: <http://www.financialstability.gov/docs/regulatoryreform/07222009/titleVI.pdf>.

<sup>39</sup> See § 603 of Title VI.

<sup>40</sup> See § 605 of Title VI.

<sup>41</sup> See § 603.

## Part II: The Administration's Proposed OTC Derivatives Bill

Following closely upon its June 17, 2009, White Paper proposing comprehensive reform of the U.S. financial regulatory system, the Obama Administration released its proposed bill for the regulation of over-the-counter (OTC) derivatives transactions, entitled "Over-the-Counter Derivatives Markets Act of 2009" (the Act).

The Act combines a number of recent proposals for regulation of OTC markets, including many of the principles described by Rep. Collin Peterson (D-MN) and Rep. Barney Frank (D-MA) in their concept paper, Description of Principles for OTC Derivatives Legislation, released on July 30, 2009. The Act is divided into two sections, one focused on the regulation of swap markets generally, and the other specifically dealing with security-based swaps. Key provisions of the Act include the following:

### Regulation of Swap Markets

- Grants the Commodity Futures Trading Commission (CFTC) jurisdiction over certain previously exempted OTC swap transactions, including those between "eligible contract participants," as defined in the Commodity Exchange Act<sup>42</sup>;
- Requires clearing of all "standardized swaps" by a registered derivatives clearing organization and trading of all standardized swaps on a regulated designated contract market or, for eligible contract participants, a registered alternative swap execution facility;
- Directs the CFTC and the Securities and Exchange Commission (SEC) to jointly adopt rules defining "standardized" swaps, but creates a presumption of standardization for swaps that are accepted for clearing by a derivatives clearing organization;
- Requires parties entering into non-standardized swaps to report these transactions to the CFTC or to a swap depository;
- Requires derivatives clearing organizations that clear swaps to register (or obtain an exemption from registration) with the CFTC;
- Requires swap dealers and major swap participants<sup>43</sup> to register with the CFTC and (1) meet minimum capital and margin requirements; (2) meet reporting and recordkeeping requirements; (3) act in accordance with business conduct standards; (4) conform to documentation and back-office standards; and (5) comply with requirements relating to documentation, position limits, disclosure, conflicts of interest, and antitrust considerations;
- Authorizes the bank regulators, the CFTC and the SEC, as applicable, to set capital and minimum initial margin levels and variation margin requirements for trading on or through registered entities;
- Authorizes the CFTC to establish aggregate position limits across commodity contracts, including those traded on foreign boards of trade and OTC swap contracts that perform or affect a significant price discovery function with respect to regulated markets;
- Provides the CFTC with jurisdiction over foreign boards of trade that provide members or other participants in the United States access to the electronic trading and order matching systems;
- Prohibits foreign boards of trade from giving participants in the United States access to electronic trading and order matching systems with respect to contracts that settle against the price of a

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<sup>42</sup> The Act defines the term "swap" which would include OTC swap transactions. The Act also requires the CFTC and SEC to jointly redefine "eligible contract participant."

<sup>43</sup> The term "major swap participant" is not specifically defined in the Act, which leaves the determination of qualifying participants to the CFTC and the SEC. The Act defines "major swap participant" as any person who is not a swap dealer and who maintains a substantial net position in outstanding swaps, other than to create and maintain an effective hedge under generally accepted accounting principles, as the Commodity Futures Trading Commission and the Securities and Exchange Commission may further jointly define by rule or regulation.

contract on a CFTC-registered entity unless such foreign boards of trade have comparable standards as U.S. boards of trade;

- Requires market participants to record large swap positions that perform or affect a significant price discovery function with respect to regulated markets and report such positions to the CFTC;
- Grants primary enforcement authority for non-security-based swap markets to the CFTC; and
- Directs the CFTC to make available to the public, in a manner that does not disclose market positions of any individual entity, aggregate data on swap trading volumes and positions.

## Regulation of Security-Based Swaps

- Adds security-based swaps to the definition of “security” under the Securities Exchange Act of 1934, as amended (the 1934 Act);
- Grants the SEC authority to regulate security-based swaps as redefined under the Act;
- Requires the clearing of all “standardized” security-based swaps by a registered clearing agency and trading of all standardized security-based swaps on a registered national securities exchange, or for eligible contract participants, on a registered alternative swap execution facility.
- Requires the reporting of all non-standardized security-based swap transactions to the SEC or to a security-based swap repository;
- Directs the CFTC and the SEC to jointly adopt rules defining “standardized” securities-based swaps, but creates a presumption of standardization for security-based swaps that are accepted for clearing by any clearing organization;
- Prohibits parties that are not eligible contract participants from entering into security-based swaps off of a registered national securities exchange;
- Requires security-based swap dealers and major security-based swap participants to register with the SEC and (1) meet minimum capital and margin requirements; (2) meet reporting and recordkeeping requirements; (3) act in accordance with business conduct standards; (4) conform to documentation and back-office standards; and (5) comply with requirements relating to documentation, position limits, disclosure, conflicts of interest, and antitrust considerations;
- Authorizes the SEC to establish aggregate position limits across securities listed on exchanges or security-based swaps that perform or affect a significant price discovery function with respect to regulated markets (the SEC may exempt from such limits any person, class of persons, transaction or class of transactions);
- Directs self-regulatory organizations to also establish position limits related to security-based swaps;
- Requires market participants to record large security-based swap positions that perform or affect a significant price discovery function with respect to regulated markets and report such positions to the SEC;
- Prohibits the sale or purchase of security-based swaps by persons who are not eligible contract participants, unless such security-based swaps are sold pursuant to an effective registration statement under the Securities Act of 1933, as amended; and
- Directs the SEC to make available to the public, in a manner that does not disclose market positions of any individual entity, aggregate data on security-based swap trading volumes and positions.

It is impossible to predict with any degree of certainty how enactment of the Treasury proposal would impact the OTC market, but it can confidently be said that the OTC market would change dramatically. One reason why it is difficult to forecast the impact is that the Treasury proposal leaves critical determinations to the future decisions of the various regulators, including not only the CFTC and the SEC but also the Board of Governors of the Federal Reserve System, the Office of the Comptroller of the Currency, and the Federal Deposit Insurance Corporation (and in cases where the SEC and the CFTC fail to jointly act in a timely manner, the Treasury Department). For example, the regulators, acting either individually or jointly, must determine:

1. Who will qualify as a “Major Swap Participant” and “Major Security-Based Swap Participants,” answering the question of what constitutes a “substantial net position in outstanding swaps”;
2. What swaps will be determined to be “standardized” and thus required to be cleared and traded on an exchange or a new “registered alternative swap execution facility”;
3. What capital requirements will be imposed on swap dealers and major swap participants; and
4. What minimum initial margin and variation margin requirements will be imposed on swap dealers and major swap participants with respect to non-standardized swaps.

Each of the above determinations could have a material impact on the future of the OTC markets and those determinations will likely not be made until many months following enactment of the proposed legislation.

Notably, although credit default swaps have been the focus of much of the recently proposed legislation, the Act does not impose any specific additional restrictions on credit default swaps. We are concerned, however, that the Act specifically states that it does not divest authority from any federal or state agencies derived from other applicable law. As such, swap transactions (including credit default swaps) may in the future become subject to additional regulation from federal or state regulatory agencies, such as state insurance regulators. Additionally, the broadening of the definition of securities under the 1934 Act may have unforeseen and unintended consequences; for example, with respect to transaction disclosure and reporting obligations.

In conclusion, it remains to be seen how the Administration’s legislative proposals will be received on Capital Hill and whether, when all is said and done, the insurance industry will be subject to a new overlay of federal regulation that is not duplicative and not inconsistent, but rather is thoughtful and manageable.