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WILL THE FEDERAL INSURANCE OFFICE IMPROVE INSURANCE REGULATION?

Elizabeth F. Brown∗

Prior to the financial crisis, insurance was the only financial service that did not have a federal regulator but relied almost exclusively on state insurance regulators. The Dodd–Frank Wall Street Reform and Consumer Protection Act (Dodd–Frank Act) began a process to address this lack of federal oversight by creating the Federal Insurance Office (FIO) within the U.S. Treasury Department. Before the crisis, state regulation of insurance was sharply criticized for its lack of uniformity, its inefficiency, and the impediments that it posed for developing international insurance norms. In the wake of the financial crisis, questions have also been raised about whether state insurance regulation was equipped to deal with the potential systemic risks posed by the insurance firms, like American Insurance Group, Inc.

The Dodd–Frank Act contains provisions that begin to tackle each of these issues, primarily through the creation of FIO. This Article will look at the creation of FIO and the role that FIO is playing to address the systemic risks posed by insurance and insurance-like products and firms and the development of insurance norms. This Article will also examine the arguments raised by many within the insurance industry that greater federal oversight of insurance is unnecessary because the state regulation already provided adequate solvency protections, insurance companies do not pose the types of systemic risks posed by banks and investment firms, and market discipline is stronger in the insurance industry than in the banking industry.

I. INTRODUCTION

Setting aside the spectacular failure of American International Group, Inc. (AIG), insurance is the financial services sector that seems to have

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performed the best during the financial crisis in terms of having the fewest number of firms that accepted some form of government bailout and the fewest number of firms that became insolvent.[1] The sheer size of the bailout for AIG, which received $182 billion in assistance from the U.S. Treasury and the Federal Reserve, however, led to calls for rethinking the way that insurance is regulated within the United States.[2] The United States is the only major industrial nation that lacks a national insurance regulator. Prior to the crisis, the variety, complexity, and expense of the state insurance regulatory structure had prompted calls for the modernization of insurance regulation, which usually referred to proposals to adopt uniform, national standards for insurance or to create an optional federal charter for insurance that would preempt most state insurance regulation.[3] In the wake of the crisis, some government officials, industry representatives, and academics have raised additional questions about the role that the fragmentary state insurance regulatory regime played and the need for more national or international insurance regulation to deal with systemic risks.[4]

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1. Only three insurance companies received aid from the federal government—AIG, Hartford Financial Services, and Lincoln National Corporation. *Bailout Recipients*, PROPUBLICA (Dec. 19, 2012), http://projects.propublica.org/bailout/list. Only eighteen insurers became insolvent in 2009, compared to 140 banks. *Insurance Oversight and Legislative Proposals: Hearing Before the H. Subcomm. on Ins., Hous. and Cmty. Opportunity of the H. Comm. on Fin. Servs*, 112th Cong. 2 (2011) (statement of Joseph Torti, III, Deputy Director of the National Association of Insurance Commissioners (NAIC) and Superintendent of Insurance and Banking, Rhode Island Department of Business Regulation) [hereinafter Torti].

2. David Goldman, *CNNMoney.com's Bailout Tracker*, CNNMoney, http://money.cnn.com/news/storysupplement/economy/bailouttracker/#AIG (last visited Apr. 30, 2013) (itemizing the $182 billion committed by various federal government programs to bailout AIG); U.S. DEP'T OF THE TREASURY, FINANCIAL REGULATORY REFORM—A NEW FOUNDATION: REBUILDING FINANCIAL SUPERVISION AND REGULATION 39–41 (2009), *available at* http://www.financialstability.gov/docs/regs/FinalReport_web.pdf [hereinafter OBAMA WHITE PAPER] (calls for enhanced oversight of insurance sector).

3. Congress considered several draft bills between 2000 and 2007, including the Insurance Consumer Protection Act of 2003, three versions of the National Insurance Act, and the State Modernization and Regulatory Transparency Act. Insurance Consumer Protection Act of 2003, S. 1373, 108th Cong., 1st Sess. (July 8, 2003) (optional federal charter); National Insurance Act of 2006, S. 2509, 109th Cong., 2d Sess. (Apr. 5, 2006) (optional federal charter); National Insurance Act of 2007, S. 40, 110th Cong., 1st Sess. (May 24, 2007) (optional federal charter); National Insurance Act of 2007, H.R. 3200, 110th Cong., 1st Sess (July 25, 2007) (optional federal charter); and State Modernization and Regulatory Transparency Act, Staff Discussion Draft (Aug. 18, 2004) [hereinafter SMART ACT] (would have imposed uniform laws on states).

4. *See, e.g.*, U.S. DEPT. OF THE TREASURY, THE DEPARTMENT OF THE TREASURY BLUEPRINT FOR A MODERNIZED FINANCIAL REGULATORY STRUCTURE (2008) [hereinafter PAULSON TREASURY BLUEPRINT]; OBAMA WHITE PAPER, *supra* note 2; Committee on Cap. Mkts. Reg., THE GLOBAL FINANCIAL CRISIS—A PLAN FOR REGULATORY REFORM (May 2009), *available at* http://www.capmktsreg.org/pdfs/TGFC-CCMR_Report_%285-26-09%29.pdf; Elizabeth F. Brown, *A Comparison of the Handling of the Financial Crisis in the United States, the United Kingdom, and Australia*, 55 VILLANOVA L. REV. 509, 574–75 (2010); Walter W. Eubanks, *Federal Financial Services Regulatory Consolidation: Structural Response to the 2007–2009 Financial Crisis* (Apr. 10, 2010),

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State insurance regulators and officials within the National Association of Insurance Commissioners (NAIC), a voluntary body comprised of the insurance commissioners from all of the states, the District of Columbia, and the U.S. territories, have attempted to push back against the movement for federal regulation by arguing that it is unnecessary.[5] They have repeatedly pointed out that AIG was brought down by its Financial Products division in London, which had issued a large number of credit default swaps (CDSs) that were not classified as insurance products and, thus were not subject to the regulatory oversight of state insurance regulators.[6]

NAIC and other proponents of these views gloss over two facts. First, they ignore the fact that the insurance companies, including insurance subsidiaries, also actively participated in the derivatives markets, including CDSs.[7] Second, they also ignore the fact that NAIC, at least for a time, thought that certain types of derivatives, which competed directly with traditional insurance products, should have been classified as insurance and regulated as insurance.[8] In 2000, New York

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available at http://assets.opencrs.com/rpts/R41176_20100412.pdf; Adrianne Fresh & Martin Neil Bailey, *What Does International Experience Tell us About Regulatory Competition?*, Pew Econ. Dept. Fin. Reform Project, Briefing Paper No. 6 (2009), *available at* http://fic.wharton.upenn.edu/fic/Policy%20page/Fresh-Baily-International-Final-TF-Correction.pdf; Howell E. Jackson, *A Pragmatic Approach to Phased Consolidation of Financial Services Regulation in the United States* (Oct. 2008), *available at* http://www2.lse.ac.uk/fmg/documents/specialPapers/2008/sp184.pdf; Investment Co. Inst., FINANCIAL SERVICES REGULATORY REFORM: DISCUSSION AND RECOMMENDATIONS (Mar. 3, 2009), *available at* http://www.ici.org/pdf/ppr_09_reg_reform.pdf; Sabrina R. Pellerin, John R. Walter, and Patricia E. Wescott, *The Consolidation of Financial Market Regulation: Pros, Cons, and Implications for the United States*, Fed. Res. Bank of Richmond Working Paper Series No. 09-08 (May 2009), *available at* http://richmondfed.org/publications/research/working_papers/2009/pdf/wp09-8.pdf.

5. Torti, *supra* note 1, at App. A, B; GOV'T ACCOUNTABILITY OFF., INSURANCE RECIPROCITY AND UNIFORMITY, GAO Rept. GOA-09-372 (Apr. 2009) [hereinafter GAO 2009 INSURANCE RPT.] at App. II: Comments from the National Association of Commissioners.

6. In response to a 2009 Government Accountability Office (GAO) report that was criticial of the states' and NAIC's efforts to improve regulatory uniformity in the areas of producer licensing, product approval, and market conduct rules, Andrew Beal, NAIC's Chief Operating Officer and Chief Legal Officer, commented:

> The report refers to AIG as 'one of our nation's largest insurers' and attributes some concern about oversight of the insurance industry to AIG's financial difficulties. In fact, AIG is a global financial services conglomerate that does business in 130 countries. AIG owns 176 other companies, in addition, to 71 U.S. state-regulated insurance subsidiaries. AIG's insurance companies remain solvent, in part, because state regulation continues to wall them off from the high-risk credit default swap activities engaged in by AIG Financial Products. AIG's Financial Products operation—created a systemic risk causing the federal government to intercede.

GAO 2009 INSURANCE RPT., *supra* note 5, at 45.

7. *See* Mary Williams Walsh, *Trading Risk Wasn't Just on the Fringe at A.I.G.*, N.Y. TIMES (Feb. 1, 2010) (noting that insurers were the third biggest issuers of CDSs and Alico, a subsidiary of AIG, was heavily involved in issuing CDSs).

8. *See* discussion *infra* Part I(B)(4) and accompanying notes.

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decided not to classify CDSs as insurance products and other states followed suit.[9]

Regulatory arbitrage and agency capture probably played a role in why U.S. state insurance regulators chose not to classify these products as insurance. Without an international agreement on how to regulate CDSs, the U.S. state regulators faced the real possibility that strict regulations in the United States would simply lead financial firms to move their CDS businesses offshore to the United Kingdom or other jurisdictions with more permissive regulatory environments. Prior to the New York decision, the International Swaps and Derivatives Association (ISDA), a trade association for financial firms involved in derivatives trades, obtained a legal opinion from Robin Potts, QC, an English barrister, that argued that CDSs should not be treated as insurance products.[10]

The decision by New York not to regulate CDSs as insurance products combined with the exemption from regulation by the federal authorities under the Commodity Futures Modernization Act of 2000[11] (CFMA) created a regulatory hole that allowed these products to make significant contribution to the financial crisis. This regulatory gap also has allowed the existing financial services regulators at both the federal and state level to point fingers and attempt to push the blame for the havoc that these instruments caused onto the other players in the government.

In many ways, the regulation, or lack thereof, for CDSs illustrates many of the problems, both domestic and international, that led to the creation of the Federal Insurance Office (FIO) in the Dodd–Frank Wall Street Reform and Consumer Protection Act (Dodd–Frank Act).[12] This Article analyzes to what extent FIO can address these problems.

The first part of this Article will discuss in more depth the problems with U.S. insurance regulation and the process that led to the creation of FIO. The second part will discuss how the Dodd–Frank Act attempted to address these problems by the creation of FIO.

The third part will discuss the factors that are possibly shaping FIO's long delayed report on how to modernize insurance regulation and what its likely proposals will be. FIO's report on how to modernize insurance regulation was due in January 2012 under the terms of the Dodd–Frank

9. N.Y. Dep't of Ins., Op. Re: Credit Default Option Facility, 2000 NY Insurance GC Opinions LEXIS 144 (2000).

10. Arthur Kimball-Stanley, *Insurance and Credit Default Swaps: Should Like Things Be Treated Alike?*, 15 CONN. INS. L. J. 241, 246–47 (2008).

11. *See* Commodity Futures Modernization Act of 2000 (codified at 7 U.S.C. § 2 (2000)).

12. Pub. L. No. 111-203, 124 Stat. 1376 (2010) (to be codified as scattered sections of 12, 15 U.S.C.) [hereinafter DODD–FRANK ACT].

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Act.[13] In March 2013, FIO's director announced that the report would finally be released before July 2013.[14]

Given the intense lobbying by the insurance industry, the fact that FIO's initial director has shown little interest in having the federal government displace the states as the primarily regulator of insurance, the dominance of state regulators and industry officials with vested interests in maintaining the status quo on FIO's advisory committee, and the fact that neither Congress nor the President are prepared to undertake drastic reforms in the area of financial services given the current budget battles, it is likely that FIO's report will only propose modest, incremental changes to the present regulatory structure.[15] Nevertheless, by giving the federal government the power to negotiate international agreements on insurance prudential standards and by creating FIO, whose mere existence will put pressure on the states to work harder on efforts to make insurance regulation more uniform and less duplicative, the Dodd–Frank Act has established mechanisms for improving insurance regulation both domestically and internationally.

II. PRE-CRISIS INSURANCE REGULATION

Insurance, unlike banking or securities, has never had a major federal regulator. To understand why, one needs to understand the history of how insurance regulation developed in the United States. Three factors explain the development of U.S. insurance regulations: the U.S. Supreme Court's flip-flopping on whether "insurance" was interstate commerce, the lack of a large enough crisis in the insurance industry to convince Congress of the need for federal regulation, and the efforts of the states to remain the sole regulators of insurance.

A. History of U.S. State Regulation of Insurance

For most of the history of the United States, state and federal regulators have regulated financial services primarily based on the institution providing the financial service or product. This type of regulation is referred to as institutional regulation. The states established separate regulators to regulate first banks, then insurance companies, and later securities firms.

13. 31 U.S.C. § 313(p)(1) (2012).

14. Mark A. Hoffman, *Federal Insurance Office Reports to Be Released in Summer: McRaith*, BUSINESS INSURANCE (Mar. 13, 2013), http://www.businessinsurance.com/article/20130313/NEWS04/130319929?tags=|59|306|76|73|80.

15. *See* discussion *infra* Part III and accompanying notes.

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States began regulating insurance during the latter half of the 1800s.[16] The first state board established to regulate insurance was the New Hampshire Board of Insurance Commissioners formed in 1851.[17] State insurance regulation during this period was not exactly effective due, in part, to the fact that many administrators were either corrupt, halfhearted, or inept.[18] In addition, no coherent economic theory underlay most insurance regulation. Instead, most regulations were a product of interest group politics and fears on the part of policyholders concerning the economic power of the insurance companies and a belief that such companies were out to defraud the public.[19]

State regulations have never been completely consistent or uniform. In fact, as the insurance companies expanded across state lines, some within the industry sought federal regulation as a means of supplanting the burden of complying with different state regulations.[20] Some insurance firms presumed that federal regulation would be weaker than the existing state regulations.[21] The decision of the U.S. Supreme Court in *Paul v. Virginia*, 75 U.S. 169 (1868), ended any movement towards federal regulation when it held that "[i]ssuing a policy of insurance [was] not a transaction of commerce" and, therefore, the federal government lacked the power to regulate insurance under the Commerce Clause.[22]

In 1944, however, the U.S. Supreme Court in *United States v. South-Eastern Underwriters Ass'n*, 322 U.S. 533 (1944), reversed its earlier decision in *Paul v. Virginia.* This time the U.S. Supreme Court held that insurance did constitute interstate commerce and was subject to federal regulation under the Commerce Clause.[23]

In spite of the decision in *South-Eastern Underwriters*, insurance was the only area of the financial services industry that did not come under at least partial federal regulation as part of the New Deal.[24] This circumstance was due largely to the efforts of NAIC. NAIC viewed the

16. Susan Randall, *Insurance Regulation in the United States: Regulatory Federalism and the National Association of Insurance Commissioners*, 26 FLA. ST. U.L. REV. 625, 630 (1999). Many of the first commissions were not independent agencies or entities, but were instead comprised of other state officials with other duties. LAWRENCE M. FRIEDMAN, A HISTORY OF AMERICAN LAW 332 (3rd ed. 2005).

17. Randall, *supra* note 16, at 630 n.18.

18. FRIEDMAN, *supra* note 16, at 332–33.

19. *Id.* at 444.

20. Randall, *supra* note 16, at 630.

21. *Id.*

22. Paul v. Virginia, 75 U.S. 168, 183 (1868).

23. United States v. South-Eastern Underwriters Ass'n, 322 U.S. 533, 552–53 (1944).

24. SHEILA BAIR, CONSUMER RAMIFICATIONS OF AN OPTIONAL FEDERAL CHARTER FOR LIFE INSURERS 6–9 (2004), *available at* http://vote.ebaymainstreet.com/afc/UMass_Report.pdf; Randall, *supra* note 16, at 633.

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decision in *South-Eastern Underwriters* as an assault on the states' power to regulate insurance and proposed a bill to reserve the power to regulate insurance to the states.[25] Congress enacted NAIC's bill in 1945 as the McCarran–Ferguson Act,[26] which stated that federal law would not regulate insurance activities, provided that those activities were related to the "business of insurance," were regulated by the state law, and were not designed to intimidate, coerce, or boycott.[27] NAIC drafted model laws governing insurance with the All-Industry Committee, a group of insurance industry representatives organized by NAIC, and worked to see that most of the states had adopted these laws by the early 1950s.[28]

In 1999, Congress enacted the Gramm–Leach–Bliley Act (GLBA),[29] which repealed portions of the Glass–Steagall Act of 1933,[30] the Bank Holding Company Act of 1956 (BHCA),[31] and other laws in order to permit banks, securities firms, insurance companies, and other entities engaged in the provision of financial services to become affiliated with one another in order to form financial conglomerates[32] that would enable them to cross sell each other's products and services. GLBA attempted to move away from institutional regulation towards functional regulation and encouraged the dismantling of the barriers between banks, securities firms, and insurance companies that had already begun to take place through rulemaking by the existing state and federal financial service regulatory agencies.[33] Under GLBA, Congress, however, left insurance

25. Randall, *supra.* note 16, at 633.

26. Ch. 20, § 1, 59 Stat. 33 (1945) (codified at 15 U.S.C. § 1011 (2012)).

27. *Id.*; Randall, *supra* note 16, at 633–34.

28. *Id.* at 634.

29. Pub. L. No. 106-102, § 1, 113 Stat. 1338 (1999) (codified in scattered sections of 12, 15, 16, 18 U.S.C.).

30. The Glass–Steagall Act is the name given to four sections of the Banking Act of 1933, Ch. 89, 48 Stat. 162 (1933). GLBA repealed Section 20 of Glass–Steagall, which prevented any Federal Reserve member bank from being affiliated with an entity principally engaged in securities and Section 33, which banned interlocking managements between Federal Reserve member banks and securities firms. GLBA, 12 U.S.C. § 377(a), 12 U.S.C. § 78(b) (2010).

31. Ch. 240, 70 Stat. 133 (1956) (codified at 12 U.S.C. §§ 1841–49).

32. The Basel Committee on Banking Supervision and the Joint Forum on Financial Conglomerates defines financial conglomerates as "any group of companies under common control whose exclusive or predominant activities consist of providing significant services in at least two different financial sectors." TRIPARTITE GRP. OF BANK, SEC., AND INS. REGULATORS, THE SUPERVISION OF FINANCIAL CONGLOMERATES ¶ 36 (July 1995), *available at* http://www.bis.org/publ/bcbs20.pdf. This Article will use this definition when referring to financial conglomerates. Financial conglomerates are distinguishable from "mixed conglomerates," in which groups of commercial or industrial enterprises include a financial institution as part of their structure. *Id.* While mixed conglomerates may raise some of the same regulatory and supervisory issues as financial conglomerates, such concerns are beyond the scope of this article.

33. Functional regulation focuses on the products or services being offered rather than the institution offering them to determine which regulator ought to regulate the products or services. For

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regulation primarily in the hands of the state insurance commissions.[34]

GLBA did require that a majority of states had to adopt either uniform or reciprocal requirements for licensing of insurance agents or a new entity, the National Association of Registered Agents and Brokers (NARAB), would be created to handle licensing for insurance agents.[35] Perhaps not surprising, when given a choice between reciprocity and uniformity, the states chose reciprocity over uniformity.[36] Reciprocity only required that states accept the licensing decisions of other states, even though their requirements might be different, while uniformity would have required the same set of requirements to be applied by the states. By 2008, NAIC had certified forty-three states as meeting the reciprocity requirements under GLBA with four more agreeing to do so by 2009.[37] Nevertheless, major states, like California, New York, and Florida, still have not complied with the reciprocity requirements.[38]

GLBA did not require state laws to be updated to deal with the new financial conglomerates created in the wake of GLBA's enactment. Generally, state insurance laws only allow the state to regulate non-insurance entities that form part of a conglomerate if they threaten the solvency of the insurance entities within the group.[39] The drafters of

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example, under GLBA, Congress envisioned the SEC regulating investments in securities regardless of whether the investment services were offered through a bank or through an independent brokerage firm. Under the institutional regulatory regime, banking regulators traditionally regulated securities offered through banks. Originally, sections 3(a)(4) and 3(a)(5) of the Securities Exchange Act of 1934 excluded banks from the definitions of broker and dealer and left the regulation of banks engaging in securities activities to the banking regulators. 15 U.S.C. §§ 78c (a)(4), (a)(5) (2010). GLBA amended those sections to eliminate the exception for banks. 15 U.S.C. § 78c. If a bank's securities activities do not fall into one of the other categories of permissible bank securities activities set forth in GLBA, then the bank is required to transfer those broker–dealer activities to an affiliated broker–dealer.

34. 15 U.S.C. § 6701. GLBA did put a few limitations on the otherwise unfettered ability of the states to regulate insurance. For example, GLBA § 104(c) prohibits states from preventing or restricting a depository institution or an affiliate of such institution from being affiliated with any person except in certain limited circumstances related to insurers. *Id.* § 6701(c)(1). Prior to GLBA's enactment, nine states and territories prohibited banks from affiliating with insurance companies. CONFERENCE OF STATE BANK SUPERVISORS, A PROFILE OF STATE-CHARTERED BANKING 117–19 (17th ed. 1998). Those states were Alaska, Arkansas, Colorado, Georgia, New York, Puerto Rico, Tennessee, Vermont, and West Virginia. *Id.*

35. 15 U.S.C. § 6751 (2010).

36. *State Insurance Regulation: Efforts to Streamline Key Licensing and Approval Processes Face Challenges: Hearing Before the H. Subcomm. on Capital Mkts., Ins. and Gov't Sponsored Enters.of the H. Comm. on Fin. Servs.*, 107th Cong. (2002) (statement of Richard J. Hillman, Director, Financial Markets and Community Investment, General Accounting Office) [hereinafter Hillman].

37. *NAIC Producer Licensing Assessment Aggregate Report of Findings* (February 19, 2008), http://www.naic.org/documents/committees_ex_pltf_plwg_PLC_assessment_aggregate_report.pdf [hereinafter NAIC PRODUCER LICENSING ASSESSMENT]; Shanique Hall, *Producer Licensing and NARAB II*, CIPR NEWSLETTER (Apr. 2012), at n.23, http://www.naic.org/cipr_newsletter_archive/vol3_prod_licensing_narab2.htm.

38. *Id.* at 2 n.1.

39. *See, e.g.*, CA Ins. Code § 1215.7(b) (examinations of affiliates done through a supervisory

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GLBA expected the new financial conglomerates to become financial holding companies (FHCs). The provisions of GLBA, however, did not require them to become FHCs, only allowed them to do so under certain conditions.[40] GLBA designated the Federal Reserve, which supervises bank holding companies (BHCs), to become the supervisor for the FHCs.[41] The financial subsidiaries of the FHCs would continue to be regulated by the relevant authority for their product or service.[42]

The vast majority of the companies that registered as FHCs before the financial crisis had previously been BHCs.[43] Only a few insurance firms that had not previously been affiliated with a commercial bank elected to become FHCs after GLBA's enactment and before the financial crisis.[44] MetLife fell into this category.[45] Many of the largest financial conglomerates with substantial insurance businesses, like AIG, did not register as FHCs.[46] The GLBA and the BHCA did not require them to

college comprised of state, federal, and international regulators); N.Y. Code § 1504 (holding company examinations permitted only if the holding company's operations are deemed to materially impact an insurance company). The differences between how the United States and Europe regulate financial conglomerates with insurance affiliates continues to be a source of international conflict. *See* Louie Woodall, *Group Supervision and Solvency Vex US and EU Regulatory Talks*, RISK.NET (Mar. 18, 2013) (discussing differences in group supervision).

40. 12 U.S.C. § 1843(k) (1999).

41. *Id*.

42. *Id.* For example, an insurance company owned by a FHC would still be subject to regulation by the state insurance regulators.

43. BD. OF GOVERNORS OF THE FED. RESERVE SYS. AND U.S. DEP'T OF THE TREASURY, REPORT TO THE CONGRESS ON FINANCIAL HOLDING COMPANIES UNDER THE GRAMM–LEACH–BLILEY ACT 3 (2003).

44. *Id.*

45. *Id.*

46. *Financial Holding Companies*, BOARD GOVERNORS FED. RES. SYS. (Aug. 6, 2004) (on file with the author) [hereinafter PRE-CRISIS FHCS]. In fact, only six of the top twenty-five largest U.S. financial services firms by revenue in 2006 were registered as FHCs. *See* PRE-CRISIS FHC; INS. INFO. INSTITUTE. AND & THE FIN. SERVICES ROUNDTABLE, THE FINANCIAL SERVICES FACT BOOK 2008 9 (2008) [hereinafter FACT BOOK 2008]. Of the twenty-five largest U.S. financial services firms by revenue in 2006, Fortune classified eleven of them as insurance firms but only one of these insurance firms, MetLife, was registered as a FHC. PRE-CRISIS FHCS, *supra*; FACT BOOK 2008, *supra*, at 9. Steve Bartlett, the President and Chief Executive Officer of the Financial Services Roundtable, commented in his testimony before the Senate Committee on Banking, Housing and Urban Affairs on July 13, 2004:

> One of the central features of GLBA was the creation of financial holding companies . . . The financial holding company structure significantly expanded the scope of activities permissible for banking firms; it did not offer insurance firms and securities firms a similar benefit. Outside of the financial holding company structure, securities and insurance firms are subject to few limitations on affiliations. Thus, it is not surprising that only a handful of securities and insurance firms have become financial holding companies.

Examination of the Gramm–Leach–Bliley Act Five Years After Its Passage: Hearing Before the S. Comm. on Banking, Hous. and Urban Affairs of the H. Comm. On Fin. Servs., 108th Cong. 69 (2004) (statement of Steve Bartlett, President and Chief Executive Officer, Financial Services Roundtable).

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register as FHCs or BHCs because they did not own a bank, although they usually owned another type of depository institution, such as a savings and loan company.[47]

B. Problems with State Regulation of Insurance

Prior to the financial crisis, five major problems existed that prompted calls for federal regulation of insurance. These problems included: (1) regulations that sometimes lacked uniformity and at other times were duplicative, (2) long time commitments for insurance providers to obtain regulatory approvals for new products and firms, (3) significant compliance costs for insurance providers, (4) regulatory gaps created by hybrid products that allowed regulatory arbitrage, and (5) the hindrance of the establishment of international standards, which created opportunities for international regulatory arbitrage.

1. State Insurance Regulations Lack Uniformity and Are Sometimes Duplicative

In order to offer a new product in all fifty states and the District of Columbia, a financial firm must determine if this product meets the definition of insurance in all of those jurisdictions.[48] Determining whether this new product qualifies as insurance in all fifty states is not an easy process because no clear, universally accepted definition for insurance exists. Several states do not even try to define insurance within their statutes.[49] In those states, one must look to state common law for how the courts have defined insurance.[50]

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47. As mentioned in note 46, eleven of the twenty-five largest U.S. financial services firms by revenue in 2006 were insurance firms. Seven of those insurance firms owned thrifts, which are more commonly known as savings and loan companies, and several of them would become targets for increased oversight by the Federal Reserve following the crisis. FACT BOOK 2008, *supra* note 46, at 9; The Allstate Corporation, Annual Report, (Form 10-K) (Feb. 21, 2007), at 14; Arthur D. Postal, *Hartford Agrees to Sell Thrift*, LifeHealthPro (May 23, 2011), http://www.lifehealthpro.com/2011/05/23/hartford-agrees-to-sell-thrift; Elizabeth D. Festa & Arthur D. Postal, *The Fed's Hit List*, LIFEHEALTHPRO (May 2, 2012), http://www.lifehealthpro.com/2012/05/02/the-feds-hit-list.

48. This problem is illustrated by the problems that arose in getting a new product, home equity insurance, approved in New York. Andrew Caplin et al, HOME EQUITY INSURANCE: A PILOT PROJECT (Yale Int'l Ctr. For Fin. Working Paper No. 03-12, 2003) at 24–28. New York ultimately concluded that home equity insurance was not insurance as New York defined it and so did not need to be licensed as such in New York. New York's approach differed from those adopted in California and Illinios. *Id*. at 5–7. Because insurance is regulated at the state level, insurance firms need approvals from each state in which they want to offer a completely new product. To offer a new product in all fifty states, requires going through fifty approval processes similar to the one that home equity insurance went through in the state of New York.

49. *See* APPLEMAN ON INSURANCE 2D § 1.03 (2007).

50. *Id.*

If the firm determines that some states will consider the product to be insurance, then it must contend with a confusing series of licensing and post-licensing requirements for both the firm offering the product and for the product. The exact type of license required varies from state to state. Some states issue a general insurance producer license, which allows an individual or an entity to sell several insurance services, while others issue separate licenses for agents and brokers or issue separate licenses for each insurance line.[51]

In addition to requiring different types of licenses, states require potential new insurance producers to fulfill a range of requirements when completing their applications. In some cases, these variations among the states' applications are due to important differences on policy questions but in others, the requirements seem to lack any rationale or policy justification.[52]

As noted in Part I(A) above, since 2009, forty-seven states do grant some form of reciprocity if a company has been granted a license in another state.[53] The introduction and passage by the U.S. House of Representatives of the National Association of Registered Agents and Brokers Reform Act of 2008 may have spurred a few of the states to agree to reciprocity.[54] The 2008 bill called for the creation of the NARAB, which was originally proposed in GLBA. As in GLBA, NARAB in the 2008 bill would have acted as a clearinghouse through which insurance producers would be allowed to provide insurance in states other than their home state without having to apply for a non-resident license as long as they paid the non-resident licensing fees. The Senate never passed a related bill and so the legislation went nowhere.

A few states with major markets, like California, Florida, and New York, still have not signed on to these reciprocity agreements because of concerns that the licensing requirement in other states do not adequately

51. *See* NAT'L ASS'N OF INS. COMM'RS, 2011 INSURANCE DEPARTMENT RESOURCES REPORT (2011) [hereinafter NAIC 2011 REPORT]. NAIC defines "producer" as a person or entity "[l]icensed to offer several insurance services." *Id*. In most cases, a producer will be a company, rather than an individual.

52. For example, New York and California require criminal background checks before allowing a person to sell insurance within their borders because they are trying to deter fraud, but some states do not require such checks. *See* Hillman, *supra* note 36, at 5. Other states, like Kentucky and Ohio, reportedly would return filings if they had been stapled improperly, which hardly seems like an important policy rationale. Andrew G. Simpson, *Leave-No-State-Regulation-Behind*, INS. J. (Sept. 6, 2004), http://www.insurancejournal.com/magazines/editorsnote/2004/09/06/45946.htm.

53. NAIC PRODUCER LICENSING ASSESSMENT, *supra* note 37, at 2 n.1 and Exhibits A, C, and D; Hall, *supra* note 37, at n.2.

54. National Association of Registered Agents and Brokers Reform Act of 2008, H.R. 5611, 110th Cong., 2nd Sess. (Sept. 22, 2008), http://www.govtrack.us/congress/bills/110/hr5611/text; govTrack.com, H.R. 5611: National Association of Registered Agents and Brokers Reform Act of 2008, http://www.govtrack.us/congress/bills/110/hr5611 [hereinafter govTrack.com NARAB 2008].

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protect consumers.[55] For example, they continue to object to the absence of any requirement in NAIC's Producer Licensing Model Act (PLMA) that all criminal background checks include fingerprint identification.[56] They feel such a requirement is essential to protect the consumers in their states from fraud by criminals who might evade detection if fingerprint identification is not done. In addition, the reciprocity arrangements of the other forty-seven states do not cover post-licensing requirements, which are also at times inconsistent and duplicative.[57]

The process became easier for life insurance, annuities, disability income, and long-term care insurance because the Interstate Insurance Product Regulation Commission (IIPRC) began operating on June 2, 2007 and covers these products.[58] The Interstate Insurance Compact, originally proposed by NAIC, created the IIPRC.[59] The IIPRC provides a central filing point for seeking licenses for insurance products from the states that are parties to the Interstate Insurance Compact.[60] Forty-one states and territories are members of the IIPRC.[61] Once again, the states with the largest insurance markets, New York, California, Connecticut, and Florida, currently are not members.[62]

2. State Regulations Are Time Consuming

In addition to having to complete multiple producer licensing and product licensing applications, insurance companies complained that having all of the state insurance regulators review and approve the necessary applications for a new product could take up to two years.[63] The state by state review of product filings persists even though the System for Electronic Rate and Form Filing (SERFF), which NAIC

55. NAIC PRODUCER LICENSING ASSESSMENT, *supra* note 37, at 2 n.1; Hall, *supra* note 37.

56. GAO 2009 INSURANCE REPORT, *supra* note 5, at 14; Hall, *supra* note 37. The forty-seven states that have agreed to reciprocity enacted some version of the PLMA. *See* Hall, *supra* note 37.

57. Hillman, *supra* note 36, at 7.

58. *News Release: Interstate Insurance Compact Open for Business*, INTERSTATE INS. PRODUCT REG. COMMISSION (June 2, 2007), http://insurancecompact.org/releases/open_for_business.htm.

59. *See id.*

60. *Id.*

61. *About the IIPRC*, INTERSTATE INS. PRODUCT REG. COMMISSION, http://www.insurancecompact.org/about.htm (last visited Apr. 30, 2013).

62. *See id.* Florida and New York, however, are considering legislation to become members of the IIPRC. *Id.*

63. Ruth Gastel, *Optional Federal Charter*, INSURANCE INFORMATION INSTITUTE INSURANCE ISSUES UPDATE (Aug. 2003); *Insurance Product Approval: The Need For Modernization: Hearing Before the H. Subcomm. on Capital Mkts., Ins., and Gov't Sponsored Enter. of the H. Comm. on Fin. Servs.*, 107th Cong. 13 (2001) (statement of William B. Fisher, Vice President and Associate General Counsel, Massachusetts Mutual Life Insurance Company).

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created in 1998, provides a uniform format for insurers to submit filings for product approvals.[64] States rely on a diverse range of procedures when reviewing product filings and require different types of additional documentation as part of their reviews.[65]

The Interstate Insurance Compact has substantially reduced these problems for certain life, annuity, disability income, and long-term care products by having the IIPRC approve the products, but only for the states that are members of the Compact.[66] The fact that the states with the largest insurance markets (New York, California, and Florida) are not members of the Compact means that delays to get approvals from those states could still be lengthy. A 2004 study conducted by the University of Massachusetts Isenberg School of Management found that insurers reported that in the five largest states in which they did business, getting a life insurance product approved took six to nine months.[67] Even for products covered by the Compact, the Compact allows member states to make certain individualized decisions with regard to product approvals.[68]

3. State Regulations Are Expensive

Insurance companies must pay a variety of fees and taxes to each of the states in which they operate. Most states use these fees and taxes on insurance products to cover the budgets of their insurance regulators. The states within the United States pay in aggregate considerably more than any other developed country to regulate insurance. With these higher costs, it is questionable whether the United States is getting a proportionally better regulatory regime for its money.

Looking at how much the governments in the United States, the United Kingdom, and Germany spent in 2007 at the beginning of the financial crisis illustrates this point. Prior to the financial crisis, the UK Financial Services Authority (UK FSA) regularly included data on how much certain nations spent to regulate financial services in its annual reports.[69] According to the data collected by the UK FSA for

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64. GAO 2009 INSURANCE RPT., *supra* note 5, at 5.

65. *Id.*

66. *Id.*

67. BAIR, *supra* note 24, at 42–43. Out of 383 companies in the life insurance business that were sent the survey, 129 companies responded.

68. *Id.*

69. *See, e.g.*, FINANCIAL SERVICES AUTHORITY, ANNUAL REPORT 2007/08, 104–09 (2008) [hereinafter UK FSA 2007/08 ANNUAL REPT.]. The UK FSA raised the following caveats regarding the comparability of the data collected: (1) the figures do not necessarily relate to the same accounting period and may not have been compiled on the same basis; (2) labor and other costs vary between countries; (3) variations in exchange rates will affect the results expressed in a single currency; (4) the

comparison with its 2007/08 fiscal year, which began on April 1, 2007 and ended on March 31, 2008, the total annual regulatory costs incurred by the states within the United States to regulate insurance were approximately $1.2 billion, or almost nineteen times more than the total annual insurance regulatory costs for the UK FSA, which were $63.51 million, and about twenty-nine times more than the total annual insurance regulatory costs for Germany's Bundesanstalt für Finanzdienstleistungsaufsicht[70] (BaFin), which were $41.68 million.[71]

The differences in the regulatory costs cannot be accounted for solely by the size of the insurance markets among these nations. During roughly the same period, the total insurance premiums in the United States equaled approximately $1.4 trillion, which was about three times more than the $510.1 billion in total premiums in the United Kingdom and five times more than the $267.9 billion total premiums in Germany.[72]

Simply looking at the amount that the government spends to regulate insurance underestimates the total costs to the United States of the current regulatory regime because it does not capture how much more companies and individuals must pay to operate within the system. The regulatory costs are a fraction of the fees, assessments, and taxes that the state and federal governments charge financial service firms. The total amount budgeted for all of the state insurance commissions in 2011 was about $1.3 billion but the total revenues collected by the state insurance commissions in 2011 was $19.2 billion.[73] In other words, only 6.7 percent of the revenues that the states collect from insurance companies went towards insurance regulation in 2011. Most states have a

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scope of the responsibility of the regulatory authorities differ from one country to the next; and (5) material differences in the size and nature of the financial services industries in each country exist. *Id.* at 105. The UK FSA stopped including such data beginning with its Annual Report 2009/10. FINANCIAL SERVICES AUTHORITY, ANNUAL REPORT 2008/09, 122–23 (2009); FINANCIAL SERVICES AUTHORITY, ANNUAL REPORT 2009/10 (2010); FINANCIAL SERVICES AUTHORITY, ANNUAL REPORT 2010/11 (2011); FINANCIAL SERVICES AUTHORITY, ANNUAL REPORT 2011/12 (2012).

70. The English translation of the name for this agency is the Federal Financial Supervisory Authority.

71. *See* UK FSA 2007/08 ANNUAL REPT, *supra* note 69, at 104–09. The amounts cited in the original report were in pounds. For purposes of this paper, the exchange rate used to convert the amounts cited in the UK FSA's report back into dollars was the U.S. dollar-pound exchange rate for Apr. 30, 2008 of $1.9847=£1. *Historical Rate for the UK Pound*, BOARD GOVERNORS FED. RES., www.federalreserve.gov/releases/H10/Hist/dat00_uk.htm (last visited Apr. 30, 2013) The U.S. total cited in the report was based on information provided by NAIC. *See* UK FSA 2007/08 ANNUAL REPT., *supra* note 69, at 107.

72. UK FSA 2007/08 ANNUAL REPT., *supra* note 69, at 107. The amounts cited in the original report were in pounds. For purposes of this paper, the exchange rate used to convert the amounts cited in the UK FSA's report back into dollars was the U.S. dollar–pound exchange rate for Apr. 30, 2008 of $1.9847=£1. *Historical Rate for the UK Pound*, BOARD GOVERNORS FED. RES., www.federalreserve.gov/releases/H10/Hist/dat00_uk.htm (last visited Apr. 30, 2013).

73. NAIC 2011 REPORT, *supra* note 51, at 32, 36.

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dedicated funding systems under which the fees, assessments, fines, and penalties can only be used by the state insurance commission, but the taxes levied on the insurance companies goes back into the states' general funds to pay for any other state operations, such as roads and schools.[74] In 2011, $15.4 billion or over 80 percent of the revenues generated by the states from insurance companies were from taxes, which primarily went back into the states' general funds to support state operations other than insurance regulation.[75]

The excessive cost problem is further compounded by the fact that most of the revenues generated by the states usually come from foreign insurance companies. A foreign insurance company is any insurance company that is writing insurance in a state in which it is not domiciled. In 2011, the total number of domestic insurers (insurers domiciled in the state in which the business is written) in the fifty states and the District of Columbia equaled 6,296, or an average of 117 domestic insurers per state.[76] The state with the fewest number of domestic insurers in 2011 was Wyoming with five, and the state with the largest number of domestic insurers, excluding captive insurers, in 2011 was New York with 616.[77]

The number of foreign insurers is larger than the number of domestic insurers in every state. The ratio of foreign insurers to domestic insurers ranges from 1.8 to 1 in New York to 280 to 1 in Wyoming.[78] On average, 1,341 foreign insurers operate in each state, which means that, on average, foreign insurers comprise a little over 90 percent of the total number of insurers in a state.[79] If one assumes that states generally charge the same taxes, fees, assessments, fines, and penalties to foreign

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74. *Id.* at 27, 31.

75. *Id.* at 31.

76. *Id.* at 36.

77. *Id*. The top five states based on the number of domestic insurers were: New York (616), Florida (501), Texas (430), Wisconsin (390) and Illinois (358). *Id.* If captive insurers were included, Vermont would have more domestic insurance companies than New York. Captive insurers are insurance companies formed to provide insurance and risk management services to their parent company and its affiliates. States tend to impose weaker regulations and few consumer protections on captive insurers. Lynnley Browning, *Vermont Becomes 'Offshore' Insurance Haven*, N.Y. TIMES, Apr. 4, 2007. NAIC statistics regarding domestic insurance companies used to include captive insurers. However, when the domestic insurers included captive insurers, the number of domestic insurers in Vermont surpassed the number in New York in 2005. NAT'L ASS'N OF INS. COMM'RS, 2004 INSURANCE DEPARTMENT RESOURCES REPORT 46 (2005) (shows New York has a total of 617 while Vermont has 546); NAT'L ASS'N OF INS. COMM'RS, 2005 INSURANCE DEPARTMENT RESOURCES REPORT 46 (2006) (showes New York has a total of 559 while Vermont has a total of 567). Vermont has made a concerted effort to market itself as a haven for captive insurance companies. Browning, *supra.* The captive insurance sector is one of the ten largest employers in Vermont and the premiums paid account for 2 percent of Vermont's state budget. *Id.*

78. NAIC RESOURCES REPORT 2011, *supra* note 51, at 36.

79. *Id.*

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insurers as to domestic insurers, then states raised about $17.6 billion, or over 90 percent of the $19.2 billion in total revenue that the states earned from taxes, fees, assessments, fines, penalties, and other sources from foreign insurers in 2011.[80]

In the 2004 study by the University of Massachusetts Isenberg School of Management, the industry survey data showed that life insurers spent about 65 percent of their regulatory dollars on "front-end" regulation, presumably due to the need to deal with multiple jurisdictions in company and producer licensing and product filings.[81] In addition, according to the respondents, the average cost per company of licensing in an additional state was $8,673 while the average cost per fleet of licensing in another state was $23,279.[82] The average cost of producer licensing in another state per fleet was $136 per agent, or a total of $28,199, and per company was $36 per agent, or a total of $11,280.[83] The average cost of licensing another product in another state was $12,348 per fleet and $4,715 per company.[84]

The significant costs involved, both in terms of time and money, for a company to get licensed as an insurance provider and to get its products licensed have created substantial barriers to entry in the insurance industry. In fact, about 66 percent of the respondents to the survey conducted as part of the University of Massachusetts study on life insurers considered the state regulatory structure for insurance to impose barriers to entry, particularly for small firms.[85] These barriers protect existing insurance providers from competition and deprive consumers of lower cost products and more innovative products. In addition, insurance companies will attempt to pass along to their business and consumer clients the costs that they incur to comply with the existing regulatory regime in the United States.[86] Thus, consumers and the U.S. economy as a whole pay a large price for the current state regulatory structure for insurance.

4. The State System Contained Regulatory Gaps and Allowed Regulatory Arbitrage

Functional regulation only works well when the definitions of

80. *Id.* at 32, 36.

81. BAIR, *supra* note 24, at i–ii.

82. *Id.* at 51.

83. *Id.*

84. *Id.*

85. *Id.*

86. *See* STEVEN W. POTTIER, STATE REGULATION OF LIFE INSURERS: IMPLICATIONS FOR ECONOMIC EFFICIENCY AND FINANCIAL STRENGTH (2007), *available at* http://www.aria.org/meetings/2007papers/IIB%20-%202%20-%20Pottier.pdf.

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banking, securities, and insurance are clear and allow firms and products to be easily categorized. Unfortunately, the definitions for banking, securities, and insurance do not provide hard and fast rules that enable regulators to place firms or products easily in one category or another. This situation is due in part to the fact that statutes and courts have always struggled with how to define banking, securities, and insurance products. It has been exacerbated by the fact that financial services firms constantly create new hybrid financial products that fall within the gaps between the definitions for banking, securities, and insurance products allowing the hybrid products to avoid government regulations, at least for awhile.

As noted in Part I(B)(1) above, there is no single, all-purpose definition for insurance. The definitions that do exist grew out of the institutional regulatory regime and tend to define insurance in relation to the entity offering the product or service. For example, insurance regulators tend to exclude self-insurance that arises when an individual or an entity sets aside funds or other assets to cover any future losses or damages, as beyond the scope of their regulatory powers. They do so on the grounds that "insurance" is about risk sharing and self-insurance does not involve risk sharing, but instead involves risk retention.[87] On the other hand, the law does not leave self-insurance completely unregulated, but instead sometimes limits the ability of individuals or entities to engage in self-insurance by mandating that everyone must obtain certain types of insurance, such as automobile insurance.

To illustrate how the definitions of insurance led to regulatory gaps, one need only look at why investment banks originally created certain derivatives, like credit default swaps, and how they worked to keep them unregulated.[88] Bankers Trust and JP Morgan created the first CDSs in the early 1990s.[89] They wanted to create an instrument that would help banks to protect themselves against the downside risk of

87. *See generally* APPLEMAN, *supra* note 49.

88. Outlining all of the different ways that derivatives are used as substitutes for insurance is beyond the scope of this paper. For a fuller discussion of some of these instruments, see PETER CARAYANNOPOULOS ET AL., INSURANCE SECURITIZATION: CATASTROPHIC EVENT EXPOSURE AND THE ROLE OF INSURANCE LINKED SECURITIES IN ADDRESSING RISK (2003); J. David Cummins, *CAT Bonds and Other Risk-Linked Securities: State of the Market and Recent Developments* (2007), *available at* http://ssrn.com/abstract=1057401; Tamar Frankel & Joseph W. LaPlume, *Securitizing Insurance Risks*, 19 Ann. REV. BANKING L. 203 (2000); Richard W. Gorvett, *Insurance Securitization: The Development of a New Asset Class* (1999), *available at* http://www.casact.org/pubs/dpp/dpp99/99dpp133.pdf; Changki Kim, Taehan Bae & Reginald J. Kulperger, *Securitization of Motor Insurance Loss Rate Risks* (2008), *available at* http://ssrn.com/abstract=1134606.

89. Harry Wilson, *A Short History of Credit Default Swaps*, TELEGRAPH (Sept. 6, 2011, 7:44 PM), *available at* http://www.telegraph.co.uk/finance/newsbysector/banksandfinance/8745511/A-short-history-of-credit-default-swaps.html.

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default on their loans to their large corporate clients.[90]

At the time, federal and state laws prohibited Bankers Trust, which was an investment bank, from selling insurance products, such as financial guarantee insurance. Financial guarantee insurance is "[a]n insurance policy covering a lender from liability resulting from the failure of a borrower to repay the loan."[91] In 1991, only state-licensed insurance companies could sell insurance products and federal laws prohibited large commercial and investment banks from being affiliated with insurance companies.[92]

In order to sidestep the state insurance regulations, Bankers Trust and JP Morgan needed to create a product that they could argue did not meet the definition of "insurance." They needed to do this even after Congress enacted the CFMA because the CFMA did not exempt derivatives from state insurance laws, but only from state gaming and bucket shop laws.[93]

The banks attempted to avoid insurance regulations by making payments under a CDS tied only to whether the relevant borrower defaulted and not on whether the holder of the CDS actually suffered a loss due to the default. Thus, they did not make it a requirement that someone buying a CDS had to actually own the loan that was the subject of the CDS.

Originally, however, the entities seeking the CDS protection usually were the ones that had made the loan and would actually suffer a loss if the borrower defaulted.[94] Such CDSs would later be referred to as "covered" CDSs.[95] In addition, each CDS contract was relatively costly to create because it had to be individually negotiated in a process that could potentially take months.[96] Eventually, ISDA would devise standardized CDS contracts that allowed the transactions to be

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90. *See id.*

91. *Financial Guarantee Insurance*, FARLEX FINANCIAL DICTIONARY (2011), *available at* http://financial-dictionary.thefreedictionary.com/Financial+Guarantee+Insurance.

92. This prohibition on banks and insurance company affiliations was eroded over time and eventually eliminated with the passage of the Gramm–Leach–Bliley Act. *See* GLBA,12 U.S.C. §§ 78, 377 (2010).

93. *See* Commodity Futures Modernization Act of 2000 (codified at 7 U.S.C. § 2 (2000)) at 7 U.S.C. § 27f (2010). Gaming laws generally prohibit or severely limited gambling. Bucket shop laws prohibit bets being made on changes in the prices of stocks or commodities, in which the parties never intend to actually deliver the stocks or commodities involved.

94. *The Role of Financial Derivatives in the Current Financial Crisis: Hearing Before the S. Comm on Agric., Nutrition, and Forestry*, 110th Cong. 2–3 (2008) (statement of Eric Dinallo, Superintendent, New York State Insurance Department) [hereinafter Dinallo].

95. *Id.* at 3.

96. *See* Michael Pohly & James Vore, *Insurers Eye Derivatives for Credit Risk*, 106 Nat'l Underwriter/Prop. Casualty Risk & Benefits Mgmt. 38 (2002); René M. Stulz, *Credit Default Swaps and the Credit Crisis*, 24 J. ECON. PERSPECTIVES 73, 78 (2010).

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negotiated more quickly than the earlier, bespoke deals and brought down the costs of creating a CDS.[97] In addition, standardization allowed CDSs to become easily traded. With the reduction in costs and the increased ease of trade, speculators, who did not own the loans that, if the borrowers defaulted, would require payments under the relevant CDSs, increasingly dominated the CDS markets.[98] Such CDS transactions became known as "naked" CDSs.[99]

The existence of the naked CDSs enabled the banks to convince many insurance regulators to view CDSs as something other than insurance and thus, not subject to insurance laws and regulations. The states and U.S. courts have developed several tests to determine when something is insurance and when it is not. The one that is most relevant for how New York's insurance regulators viewed CDSs is the Substantial Control Test.[100]

The Substantial Control Test grew out of Professor William R. Vance's description of an insurance contract in 1904.[101] Under his definition, an insurance contract was between the insurer and the insured and required five elements:

> (1) The insured must possess an interest, the insurable interest, in the thing being insured and the value of that interest must be able to be assessed;
>
> (2) The insured must be subject to a risk of loss if the insured interest is destroyed or damaged by the happening of certain specified fortuitous events;
>
> (3) The insurer assumes the risk of loss (also known as risk transference);
>
> (4) The insurer assumes this risk of loss as part of a general plan to distribute actual losses amongst a large group bearing similar risks; and
>
> (5) The insured pays a fee to the insurer, which goes into a general insurance fund, as consideration for the insurer's promise to assume the risk of loss.[102]

New York's statutory definition for insurance seems to be based on this test. New York defines an insurance contract as:

> [A]ny agreement or other transaction whereby one party, the 'insurer' is obligated to confer benefit of pecuniary value upon another party, the 'insured' or 'beneficiary' dependent upon the happening of a fortuitous

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97. Pohly & Vore, *supra* note 96.
98. *See id.*; Stulz, *supra* note 96.
99. *See* Pohly & Vore, *supra* note 96; Stulz, *supra* note 96, at 84–85.
100. APPLEMAN, *supra* note 49, § 1.4.
101. *Id.*
102. *Id.*

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> event in which the insured or beneficiary has, or is expected to have at the time of such happening, a material interest which will be adversely affected by the happening of such event.[103]

The language requiring that the agreement compensate when an insured's interest is adversely affected tracks with Professor Vance's requirement that the insured suffer a "loss" if his insured interest is destroyed or damaged.

In June of 2000, the New York State Department of Insurance General Counsel was asked to opine on the following question: "Does a credit default swap transaction, wherein the counterparty ('seller') will make payment to the buyer upon the happening of a negative credit event and such payment is not dependent upon the buyer having suffered a loss, constitute a contract of insurance under the insurance law?"[104] The question was specifically phrased to highlight the lack of any requirement that the CDS buyer had suffered a "loss" in order to receive payment.[105] It was designed to convince the New York State Department of Insurance to opine that CDSs were not insurance and the New York State Department of Insurance did just that. The question was phrased only to deal with naked CDSs but both the industry and the New York State Department of Insurance treated it as if the opinion covered all CDS transactions.[106] Some banks entered into covered CDSs with the intent to protect against loan losses, and therefore covered CDSs arguably should have fallen within the New York statutory definition of insurance.[107] In 2004, New York amended its insurance laws to specifically exclude all CDSs from being classified as insurance.[108]

The result in New York was not inevitable. New York could have used other definitions for insurance that would have classified CDSs as insurance. In fact, after GLBA and CFMA were enacted, NAIC attempted to convince state regulators to include derivatives within their regulatory definitions of insurance. NAIC was specifically concerned about weather derivatives, but a definition of insurance broad enough to encompass weather derivatives would have also classified other derivatives, like CDSs, as insurance.

Weather derivatives are usually based on indexes that rely on the

103. N.Y. INSURANCE LAW § 1101 (McKinney 2011). New York defines a fortuitous event as "any occurrence or failure to occur which is, or is assumed by the parties to be, to a substantial extent beyond the control of either party." *Id.*

104. N.Y. Dep't of Ins., Op. Re: Credit Default Option Facility, 2000 NY Insurance GC Opinions LEXIS 144 (2000).

105. Dinallo, *supra* note 94, at 5.

106. *Id.*

107. *Id.*

108. N.Y. INSURANCE LAW § 6901(j–l) (McKinney 2011).

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average temperatures and precipitation.[109] They are sometimes structured as swaps or options.[110] A weather option, for example, requires the seller to pay the buyer an agreed upon amount at a set time if certain weather conditions develop, such as when the temperature is above normal by ten degrees during the summer.[111] Weather derivatives can be used to protect against crop damage due to drought, or property damage due to a hurricane. From the buyer's perspective, weather derivatives may sometimes be better than more traditional insurance policies because weather derivatives do not require the buyer to show that he actually suffered harm before receiving payment. Weather derivatives have become more popular in recent years, with over $121 billion worth of weather derivative contracts traded either over the counter or on the Chicago Mercantile Exchange between 2004 and 2009.[112]

In 2003, NAIC released a Draft White Paper on whether weather derivatives should fit within the definition of insurance.[113] NAIC focused on two factors that it felt should justify classifying weather derivatives as insurance.[114] First, weather derivatives involved the transfer of risk for a fee and usually "businesses that are involved in accepting risk transfers for a fee are known as insurers and the fee paid by the entity seeking to transfer its risk is known as premium."[115] Essentially, NAIC was arguing for the same kind of substance over form analysis that is used in tax to recharacterize transactions whose form is designed to avoid the taxes that normally would be imposed based on the actual substance of the deal.[116] Second, allowing unregulated speculation in weather derivatives would promote price manipulation and, thus, create additional risks to the system rather than reducing risks.[117] Both of these arguments could also be applied to CDSs. In fact, in the wake of the financial crisis, Eric Dinallo, then Superintendent for the New York State Department of Insurance, testified before Congress that naked CDSs had added risks to the financial system by encouraging gambling rather than socially useful

109. INS. INFO. INST, THE FINANCIAL SERVICES FACT BOOK 2010 95 (2010).

110. *Id*.

111. *Id*.

112. *Id*. at 96.

113. National Ass'n of Ins. Comm'rs., *Weather Financial Instruments (Temperature): Insurance or Capital Markets Products?* (NAIC Draft White Paper, Sept. 2, 2003) [hereinafter NAIC WHITE PAPER].

114. Robert F. Schwartz, *Risk Distribution in Capital Markets: Credit Default Swaps, Insurance and a Theory of Demarcation*, 12 FORDHAM J. CORP. & FIN. L. 167, 184–86 (2007).

115. *Id.* at 184–85; NAIC WHITE PAPER, *supra* note 113, at 368.

116. Schwartz, *supra* note 114, at 184–85.

117. NAIC WHITE PAPER, *supra* note 113, at 368–69.

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risk mitigation.[118]

ISDA, the Bond Market Association, and many academics have pushed back against attempts to classify CDSs as insurance. They have argued that the definition of insurance should focus on the concepts of "insurable interest" and "loss indemnification."[119]

It is worth noting, however, that not all traditional insurance products actually require the buyer to suffer a loss. Annuities are a traditional insurance product that involve risk transference but do not indemnify the purchaser for a loss. In fact, insurance companies market annuities as investment vehicles. With an annuity, the buyer pays for the right to receive a stream of payments in the future until the death of the annuitant. The terms for annuities can vary based on the nature of the underlying investment, the primary purpose of the annuity, the type of pay-out commitment, and the tax status of the annuity. The annuity can guarantee a fixed rate of return on the underlying investment or a variable rate of return. Annuities with fixed rates of return are called fixed annuities and those with variable rates of return are called variable annuities. In order to achieve the variable rates of return, variable annuities invest in stocks, bonds, and other investments. The primary purpose of the annuity can be to accumulate wealth or to provide a guaranteed pay-out for a certain period of time.

Annuities can serve as a tax deferral vehicle, similar to a 401(k) plan or an individual retirement account (IRA), but without the limits on contributions that those investment vehicles entail. Annuities are marketed as investment vehicles, particularly for those concerned about retirement. Annuities are pushed by the insurance industry as an alternative to or a supplement to more traditional investment vehicles, such as mutual funds, IRAs, and 401(k) plans.

Retirees sometimes find annuities' guaranteed payments until the end of their lives preferable to trying to managing their funds in a 401(k) or IRA plan because the guaranteed payments allows them to shift their longevity risk onto the insurance companies providing the annuities. Longevity risk is the risk that a person will live longer than predicted. It

118. *See* Dinallo, *supra* note 94, at 3.

119. *See, e.g.*, Thomas Lee Hazen, *Disparate Regulatory Schemes for Parallel Activities: Securities Regulation, Derivatives Regulation, Gambling, and Insurance*, 24 ANN. REV. BANKING & FIN. L. 375, 401–12, 416–18 (2005) (noting that derivatives often fail to meet insurable interest requirements needed to be classified as insurance); M. Todd Henderson, *Credit Derivatives are not "Insurance"*, 16 CONN. INS. L. J. 1 (2009); Kimball-Stanley, *supra* note 10, at 246–47 (discussing the Robin Potts, QC, opinion relied upon by ISDA and the Bond Market Association on why CDSs are not insurance); Schwartz, *supra* note 114, at 174 ("The aim of this article is to develop an explanatory theory of why CDS are not insurance."); Jeffrey Thomas, *Insurance Perspectives on Federal Financial Regulatory Reform: Addressing Misunderstandings and Providing a View from a Different Paradigm*, 55 VILLANOVA L. R. 773, 776–78 (2010), *available at* http://www.law.villanova.edu/lawreview/wp-content/uploads/2011/12/VLR308.pdf (CDSs are not insurance because they do not involve pooling).

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is problematic for people relying on savings or securities to fund their retirement because they may outlive their assets and end up having to rely solely on government programs, like Social Security and Medicare, to cover their living expenses. In these cases, the retirees have not suffered a loss in the sense of being deprived of something of value that they actually possessed because 401(k) and IRA plans provide no guarantees that their funds will be able to provide a fixed level of funds to cover a retiree's living expenses for any period of time.

Thus, when a retiree decides to shift his longevity risk to an insurance company by buying an annuity, the insurance product, the annuity, is qualitatively different from traditional life insurance or property/casualty insurance. In the case of life insurance or property/casualty insurance, the policy indemnifies the insured for being deprived of something that they did actually possess at one time.

In the case of annuities, the insurance company finds longevity risk problematic if it must pay out more than it originally estimated because the annuitant has lived longer than the insurance company's actuaries predicted. While the insurance company may suffer a loss in the form of lower profits because of these larger pay-outs, such losses are little different than the losses suffered by the firm issuing a CDS who misjudges the likelihood that the company issuing the bonds, on which the CDS was written, will default. Definitions of "insurance", like the Substantial Control Test, however, are not concerned with the losses suffered by the insurer, but only with the losses suffered by the insured.

Following the financial crisis, New York and several other states changed their minds regarding whether CDSs should be regulated as insurance. On September 22, 2008, the New York Insurance Department decided that beginning in January 2009, the credit default swaps, in which the buyer of the swap owns the underlying bond that it meant to back, would be classified as insurance in New York.[120] It ultimately decided to put these new regulations on hold until it could assess what reforms the federal government would enact and whether those reforms would go far enough to correct the problem.[121]

5. The State System Hindered the Establishment of International Standards

The development of international norms and standards for many types

120. Danny Hakim, *New York to Regulate Credit Default Swaps*, N.Y. TIMES (Sept. 23, 2008), http://www.nytimes.com/2008/09/23/business/23swap.html.

121. Leah Campbell & Robin Choi, *State Initiatives to Regulate Credit Default Swaps Deferred Pending Federal Action*, METROPOLITAN CORP. COUNSEL (Sept. 2009), at 20, *available at* http://www.metrocorpcounsel.com/pdf/2009/September/20.pdf.

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of insurance is a relatively new phenomenon when compared with the development of international norms and standards for other commercial activities, such as trade in goods or banking. This is perhaps because many types of insurance were considered to be governed primarily by local, rather than international conditions. Life insurance, property and casualty insurance, and health insurance comprise the largest sectors within insurance based on premiums. In each case, local laws and local conditions have a significant impact on shaping the risks being insured against by insurance firms. State insurance commissioners have relied upon the local character of insurance markets as a major justification for why they should regulate insurance rather than the federal government.

Nevertheless, a number of factors are putting increasing pressure on governments and market participants to develop international norms and standards for insurance. Financial services markets are increasingly interconnected, which means that the risks posed by one region or sector can more easily spill out and affect other regions and sectors. This interconnectedness is due in part to the increasing number of financial products and services that are fungible with one another. Hybrid products that contain elements of traditional banking, securities or insurance products are being created more frequently now than ever before. These products are breaking down the distinctions between the banking, securities, and insurance sectors. The result is that financial services now form a continuum between products that are predominately characterized by their risk transference attributes and products that are predominately characterized by their investment attributes rather than distinct silos for banking, insurance, and securities.

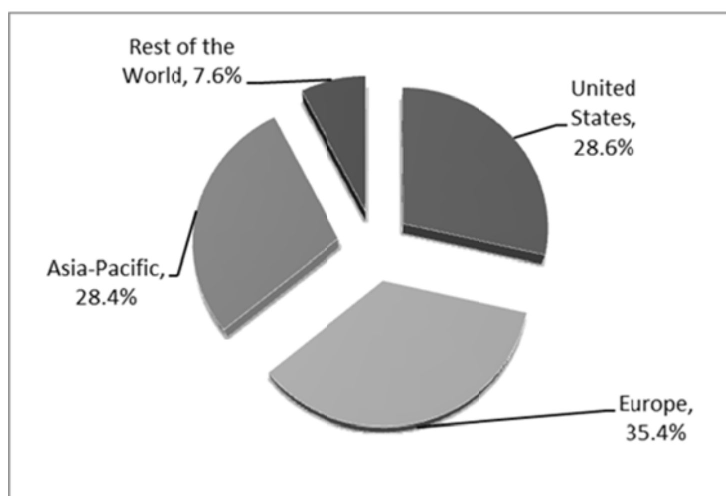
Financial products also are linking previously separate sectors as products from one sector are repackaged to spread and diversify the risks. The financial crisis has highlighted this fact as banks sold mortgages, a traditional banking product, to special purpose vehicles (SPVs) that bundled them together and issued securities that would pay based on the income stream generated by the payments on the mortgages. The risk that those securities would default was insured against either by the SPVs taking out bond insurance on the securities or by the purchasers entering into credit default swaps.

Technology also is making it easier to purchase products and services from distant suppliers. The Internet allows individual consumers to compare the prices and products of insurance companies from around the world. These opportunities occur less frequently for insurance products than for other financial products because state laws frequently require that insurers are licensed by the relevant state before they can market and sell their products to the residents of that state. All of these developments are weakening the ties that traditionally made insurance a

financial product dominated by local or regional concerns.

In addition, as the markets in the United States and the European Union mature, the multinational insurance and financial conglomerates are expanding their operations in emerging markets and ratcheting up the global competition for market shares in insurance.[122] Europe comprised 35.4 percent of the worldwide insurance premiums in 2010 while the United States comprised 28.6 percent.[123] The areas showing the largest potential for growth in the near future are the nations in Asia other than Japan and Latin America.[124]

Fig. 1: Market Shares of World Insurance Market[125]



These factors have led to calls for the development of international standards for insurance regulation. International norms can be developed in one of three ways: (1) de jure standard-setting can be developed through treaties or other binding international agreements, [126] (2) de facto standard-setting can arise by individual governments adopting similar laws without engaging in any coordination or cooperative activities with one another,[127] and (3) group or committee

122. *See* John A. Cooke & Harold D. Skipper, *An Evaluation of the US Insurance Regulation in a Competitive World Insurance Market* 3 (American Ins. Ass'n, June 27, 2008).

123. DATAMONITOR, INDUSTRY PROFILE: INSURANCE IN THE UNITED STATES 12 (2011) [hereinafter DATAMONITOR].

124. Cooke & Skipper, *supra* note 122, at 3.

125. DATAMONITOR, *supra* note 123, at 12.

126. Robert B. Ahdieh, *Foreign Affairs, International Law, and the New Federalism: Lessons from Coordination* 26 (Emory Law and Economics Research Paper No. 08-30, 2008), *available at* http://ssrn.com/abstract=1272967.

127. *Id*.

standard-setting can result in soft law such as non-binding principles or guidelines developed by intergovernmental forums.[128] Few treaties or other binding international agreements exist in the area of insurance. The General Agreement on Trade in Services[129] (GATS), the North American Free Trade Agreement[130] (NAFTA), and the European Union's Solvency II Directive[131] (Solvency II) are the most important international agreements dealing with insurance.[132] De facto standard-setting is more common as national insurance regulations generally incorporate regulations that address both prudential and market conduct risks and, thus, usually contain similar features.[133] Group or committee standard-setting that produces soft law has only developed within the past twenty years with the creation of forums like the International Association of Insurance Supervisors (IAIS) and the Financial Stability Board (FSB).[134]

The fragmentary nature of the American state-based system of insurance regulation, and the fact that the states within the United States have had difficulty adopting uniform standards, have made it difficult for the United States to negotiate international standards either in the form of soft law standards or principles or in the form of hard law found in treaties and other binding international agreements. David Snyder, Assistant General Counsel of the American Insurance Association, noted, "[d]espite the strong efforts of some regulators, the state regulatory system is structurally incapable of representing U.S. interests effectively, because it must defend the inefficient U.S. regulatory system and its lacks the legal authority to bind the United States."[135] The state insurance commissions lack the authority under the U.S. Constitution to negotiate binding international agreements on insurance.[136] The federal

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128. *Id*. at 26–27.

129. *General Agreement on Trade in Services*, WORLD TRADE ORGANIZATION, http://www.wto.org/English/docs_e/legal_e/legal_e.htm#services (follow link under the Uruguay Round Agreements, Annex 1, Annex 1B General Agreement on Trade in Services (GATS) (last visited May 17, 2013).

130. *See North American Free Trade Agreement*, NAFTA SECRETARIAT, http://www.nafta-sec-alena.org/en/view.aspx?x=343 (last visited May 17, 2013).

131. Directive 2009/138/EC of the European Parliament and of the Council of 25 Nov. 2009 on the taking-up and pursuit of the business of Insurance and Reinsurance (Solvency II), *available at* http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2009:335:0001:0155:EN:PDF [hereinafter SOLVENCY II].

132. *See* Ahdieh, *supra* note 126, at 26–27.

133. Cooke & Skipper, *supra* note 122, at 1.

134. Ahdieh, *supra* note 126, at 21–27.

135. Meg Fletcher, *U.S. Regulators Seek to Increase Visibility*, INSURANCE NEWS NET (Jan. 5, 2009), http://insurancenewsnet.com/print.aspx?id=102303&type=annuity.

136. *See* U.S. CONST. art. I, §§ 8–9 (giving to Congress the power to regulate commerce with foreign powers and prohibiting the states from negotiating international agreements with foreign powers without the consent of Congress).

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government, which has the authority under the U.S. Constitution to negotiate such agreements, had no agency prior to the enactment of the Dodd–Frank Act that was tasked with monitoring the insurance industry and that could provide useful advice during such negotiations.[137] The U.S. Trade Representative's Office, which negotiated the GATS, generally lacked the authority to bind the states and to ensure that they would enact the necessary domestic laws to codify any concession that it might make.[138] As a result, the international agreements on insurance negotiated to date contain substantial exemptions for state insurance laws.[139] The breadth of these exemptions means that the principles embodied in the GATS and other trade agreements are not binding, in many cases, on the states within the United States and the extent to which the states meet those principles is more a function of soft law rather than hard law.

Several international forums seek to promote the development of soft law international norms in the area of insurance. The primary forum is IAIS, which has over 190 members (including the insurance commissions from all fifty states within the United States) from about 140 countries.[140] Compared to the Basel Committee on Banking Supervision (Basel Committee) and International Organization of Securities Commissions (IOSCO), IAIS is a relatively new organization. It was founded in 1994, while the Basel Committee and IOSCO were formed in 1974.

IAIS has issued principles, standards, and guidance papers on a range of insurance regulatory issues such as capital adequacy, licensing, and financial conglomerates.[141] The principles and standards promulgated by IAIS have to be approved by two-thirds of its members at a general meeting.[142] Because of the large number of its members and its consensus style of approval for principles and standards, the IAIS principles and standards represent a floor when it comes to insurance regulation.

IAIS envisions risk management as primarily the responsibility of the

137. *See* U.S. CONST., art. I, § 8.

138. *See* Cooke & Skipper, *supra* note 122, at 18.

139. *Id.* at 18–19.

140. INT. ASS'N OF INS. SUPERVISORS, ANNUAL REP. 2006–07, at iv. (2007). Each of the fifty states, the District of Columbia, and the U.S. territories is a member of IAIS. *See Membership List*, NAT. ASS'N OF INS. COMMISSIONERS (2012), http://www.naic.org/documents/members_membershipli st.pdf.

141. *See, e.g.*, INT. ASS'N OF INS. SUPERVISORS, SUPERVISOR STANDARD OF LICENSING (2008); INT. ASS'N OF INS. SUPERVISORS, PRINCIPLES OF CAPITAL ADEQUACY AND SOLVENCY (2002); INT. ASS'N OF INS. SUPERVISORS, SUPERVISORY STANDARD ON GROUP COORDINATION (2000), *available at* http://www.iaisweb.org/About-the-IAIS-28.

142. *See* INT. ASS'N OF INS. SUPERVISORS BY-LAWS, art. 12(1) (2005), *available at* http://www.iaisweb.org/__temp/By-laws_2005_edition.pdf.

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insurer and that the role of the insurance regulator is to guarantee that the insurer meets this obligation.[143] IAIS standards would allow supervisors to give individual insurers a great deal of flexibility in terms of assessing and reserving for the risks that they face. IAIS believes that risk sensitive regulatory requirements, which take into account both quantitative and qualitative factors, are preferable to fixed ratios or limits because they provide insurers with better incentives for managing risk, discourage regulatory arbitrage, and enable the better use of resources.[144]

Most nations around the world do not yet regulate insurance company solvency using the risk-based approach advocated by the IAIS. The European Union has adopted a regulatory regime called Solvency II that is very similar to the standards espoused by the IAIS.[145] The states within the United States, however, use a combination of formula-based minimum reserves and factor-based minimum capital requirements that have been adjusted in recent years to include some risk-based modeling approaches.[146] NAIC adopted a Solvency Modernization Initiative Work Plan to examine to what extent U.S. insurance regulations will need to change in response to IAIS principles or other developments around the world, such as the EU Solvency II.[147]

The failure of AIG and the U.S. investment banks to predict accurately the risks to which they were exposed based on their internal models has raised doubts about the effectiveness of current risk management models and the use of mark-to-market accounting practices.[148] These concerns may lead to a reevaluation of whether

143. The *IAIS Common Structure for the Assessment of Insurer Solvency*, INTERNATIONAL ASSOCIATION OF INSURANCE SUPERVISORS 14 (February 2007), http://www.iaisweb.org/view/element_href.cfm?src=1/85.pdf.

144. *Id*. at 15–17.

145. *See* SOLVENCY II, *supra* note 131, at Art. 218–46.

146. Andrew F. Giffin & Mike Lombardi, *Financial Services: Towards a Global Solvency Standard*, 2 Emphasis 18, 20 (2006), *available at* http://www.towersperrin.com/tp/getwebcachedoc?webc=TILL/USA/2006/200605/SolvenyQ2523.pdf.

147. Richard Crump, *Solvency II: Setting a Global Standard*, REACTIONS (Aug. 1, 2008), *available at* http://www.reactionsnet.com/Article/2148178/Solvency-II-Setting-a-global-standard.html.

148. Pursuant to the Congressional requirement in the Emergency Economic Stabilization Act of 2008, the SEC issued a report in December on impact of mark-to-market accounting in the current financial crisis. SEC, REPORT AND RECOMMENDATIONS PURSUANT TO SECTION 133 OF THE EMERGENCY ECONOMIC STABILIZATION ACT OF 2008: MARK-TO-MARKET ACCOUNTING (2008), a*vailable at* http://www.sec.gov/news/studies/2008/marktomarket123008.pdf. This report concluded that mark-to-market accounting had not played a significant role in the current crisis and that the benefits to investors from the transparency provided by mark-to-market accounting outweighed any costs associated with the practice. *Id*. at 7–8. The report did make some recommendations about how fair value and mark-to-market accounting could be improved. *Id*. at 7–10. This report, however, has not halted the ongoing debate about whether mark-to-market accounting contributed to the current financial crisis. Even before the current financial began, some academics raised the possibility that mark-to-market accounting might cause a financial crisis when one would not have occurred using traditional

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allowing risk-based regulation using company generated models, as IAIS has proposed, is prudent.

Finally, it is important to note that the Financial Stability Board has a growing role in the development of international norms for financial supervision and regulation, including in the area of insurance. The FSB is the international body tasked with coordinating the work of national regulators and international standard setting bodies for financial services.[149] To promote financial stability, the FSB is attempting to identify systemically important financial institutions (SIFIs), which would include global or highly interconnected insurers or insurance groups, like AIG. The FSB's work influences and is influenced by the work of national bodies tasked with promoting financial stability, like the Financial Stability Oversight Council (FSOC) in the United States. The FSB's effort to identify SIFIs has spurred IAIS to undertake its own determination of which insurers or insurance groups are systemically important.

III. THE DODD–FRANK ACT AND INSURANCE

The Dodd–Frank Act contains several provisions that affect insurance regulation. In addition to the creation of FIO, the Dodd–Frank Act sets forth new rules for non-admitted insurers and reinsurance that preempt parts of the existing state rules, allows the FSOC to designated certain insurance companies as systemically important and subject to regulation by the Federal Reserve, establishes new rules for swaps that insurers and other financial firms use, and puts limits on proprietary trading by financial firms under certain conditions under a rule commonly referred to as the Volcker Rule.[150] Congress, however, intended the Federal Insurance Office to be the main federal entity dealing with insurance issues.

A. Origins of the FIO

The Dodd–Frank Act was not the first governmental proposal to create a federal office of insurance. Since GLBA was enacted, some

accounting. *See, e.g.*, Franklin Allen & Elena Carletti, *Mark-to-Market Accounting and Liquidity Pricing* (Financial Institutions Center, Wharton School of Business, University of Pennsylvania, No. 06-15 2006), *available at* http://fic.wharton.upenn.edu/fic/papers/06/0615.pdf.

149. *Overview*, FINANCIAL STABILITY BOARD, http://www.financialstabilityboard.org/about/overview.htm (last visited May 17, 2013).

150. Former Federal Reserve Chairman Paul Volker originally proposed this rule in 2009 and, as a result, the rule now bears his name. James B. Stewart, *Volcker Rule, Once Simple, Now Boggles*, NY TIMES (Oct. 21, 2011), http://www.nytimes.com/2011/10/22/business/volcker-rule-grows-from-simple-to-complex.html?pagewanted=all.

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members of the insurance industry have supported creating an optional federal charter for insurance similar to the dual charter structure in banking, which allowed the institutions being regulated to choose whether they would be licensed to operate by a particular state or by the federal government. All of the optional federal charter bills included some form of federal insurance office, usually modeled after the Office of the Comptroller of the Currency, to handle federal regulation of insurance.[151]

In March 2008, the U.S. Department of the Treasury under then Treasury Secretary Henry Paulson published its ideas for improving the U.S. financial regulatory structure called the *Blueprint for a Modernized Financial Regulatory Structure*.[152] The U.S. Treasury Blueprint called for the creation of an Office of Insurance Oversight to deal with international insurance regulatory issues and to advise the Secretary of the Treasury on major domestic and international insurance policy issues.[153] The Treasury considered these aspects of insurance regulation ones, on which immediate attention was needed.[154]

Representative Paul Kanjorski introduced the Insurance Information Act of 2008[155] as one way to implement the U.S. Treasury Blueprint's call for a federal office to monitor insurance. In the Insurance Information Act, the office was to be called the Office of Insurance Information (OII). In other respects, it had the same features as FIO. OII would provide information on insurance issues to Congress and to Executive Branch agencies and would have the power along with the U.S. Trade Representative's Office to negotiate treaties and international agreements setting insurance regulatory standards and practices that would preempt state insurance laws.[156] Ultimately, this idea for an office of insurance information at the federal level was incorporated into the Dodd–Frank Act as the Federal Insurance Office.

B. Functions of the FIO

The Dodd–Frank Act stipulates that FIO is responsible for all

151. *See, e.g.*, Insurance Consumer Protection Act of 2003, *supra* note 3, §§ 101–10 (would have created an insurance regulatory commission); National Insurance Act of 2006, *supra* note 3, §§ 1101–05 (would have created an office of national insurance); National Insurance Act of 2007, *supra* note 3, §§ 1101–05 (would have created an office of national insurance); National Insurance Act of 2007, *supra* note 3, §§ 1101–05 (would have created an office of national insurance).

152. PAULSON TREASURY BLUEPRINT, *supra* note 4.

153. *Id.* at 132–33.

154. *Id.*

155. Insurance Information Act of 2008, H.R. 5840, 110th Cong. (2008). This act was introduced by Rep. Paul Kanjorski (D-PA).

156. *Id.* § 313(e).

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insurance lines, except those for healthcare, long-term care, and crop insurance.[157] It has seven functions.[158] Its first function is to monitor the insurance industry to determine if any regulatory gaps could pose systemic risks.[159] In order to accomplish this function, FIO was given the power to collect information, including the power to compel insurers to provide the information that it deems necessary to achieve its functions.[160] However, before FIO can make any information requests, it must first check with the other relevant federal and state agencies and with publicly available sources to determine if it can obtain the needed data from them.[161] If it can, then FIO cannot compel any insurer to provide it with the data.[162]

FIO's second function is to monitor whether low to moderate income persons and other underserved communities have access to insurance at affordable rates.[163] Essentially, this provision is an attempt to recreate the federal protections currently provided for these groups by commercial banking in the area of insurance. Unlike the federal banking regulators, however, FIO does not have the regulatory authority to take action against insurers who refuse to provide insurance to these groups at affordable rates. FIO is required to share any information that it obtains with the relevant state regulators.[164] It would have to rely on the state regulators to take the appropriate actions to correct any problems that it finds.

FIO's third function is to make recommendations to the FSOC regarding which insurers pose systemic risks and should be classified as systemically important financial institutions (SIFIs) to be supervised by the Federal Reserve.[165] It has a non-voting seat on FSOC.[166] It holds

157. DODD–FRANK ACT, *supra* note 12; 31 U.S.C. § 313 (2010).

158. *Id.*

159. *Id.* § 313(c)(1)(A).

160. *Id.* § 313(e).

161. *Id.* § 313(e)(4).

162. *Id.*

163. *Id.* § 313(c)(1)(B).

164. *Id.* § 313(e)(4).

165. *Id.* § 313(c)(1)(C). The Dodd–Frank Act does not use the term "systemically important financial institutions", or "SIFIs", but its language embodies the same concept and as a result, the term is widely used as short-hand for the actual language in the Dodd–Frank Act. *See, e.g.*, *Systemically Important Financial Institutions and the Dodd–Frank Act: Hearing Before the H. Subcomm. on Fin. Inst. and Consumer Credit of the H. Comm. on Fin. Servs*, 112th Cong. 1 (2012) (statement of Michael S. Gibson, Director, Div. of Banking Supervision and Reg., Bd. of Gov. of the Fed. Res. System). The international Financial Stability Board defines a "systemically important financial institution" as one "whose distress or disorderly failure, because of their size, complexity and systemic interconnectedness, would cause significant disruption to the wider financial system and economic activity." FIN. STABILITY BD., POLICY MEASURES TO ADDRESS SYSTEMICALLY IMPORTANT FINANCIAL INSTITUTIONS (Nov. 4, 2011), http://www.financialstabilityboard.org/publications/r_111104bb.pdf. FSOC can classify a non-bank financial company as subject to supervision by the Federal Reserve if the "material financial

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the same non-voting status on FSOC as the state insurance regulator picked by the state insurance commissioners.[167] The only member of FSOC in the area of insurance that does have a vote is a person with insurance expertise appointed by the President with the advice and consent of the Senate.[168] As a non-voting member, FIO is entitled to attend all FSOC meetings, unless the other members deem it necessary to "safeguard and promote the free exchange of confidential supervisory information."[169]

Given FIO's limited powers on the FSOC, it is not surprising that it is difficult to determine what influence it has wielded since joining FSOC. For example, on April 5, 2013, the Board of Governors of the Federal Reserve System issued the final rule for the definition of a significant nonbank financial company, which FSOC would use to determine whether an insurance company or group poses a possible threat to the financial stability of the United States and should be regulated by the Federal Reserve.[170] While this rule clearly contains provisions to take into account certain unique features of the insurance industry, it is hard to tell how much a role FIO played in tailoring these provisions as opposed to the influence of the independent insurance representative on FSOC, the state insurance commissioners' representative on FSOC, NAIC, or the insurance industry.

FIO's last four functions all involve some aspect of international relations. It must assist the U.S. Treasury Department in administering the Terrorism Risk Insurance Act, which the U.S. government enacted in the wake of the 9/11 attacks because the private markets were unwilling or unable to provide coverage for terrorist acts.[171] FIO is responsible for coordinating federal participation in negotiating international insurance standards on prudential issues.[172] It also must

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distress at the U.S. nonbank financial company, or the nature, scope, size, scale, concentration, interconnectedness, or mix of the activities of the U.S. nonbank financial company, could pose a threat to the financial stability of the United States." DODD–FRANK ACT, *supra* note 12; 12 U.S.C. § 5323(a)(1).

166. DODD–FRANK ACT, *supra* note 12; 12 U.S.C. § 5321(b)(2).

167. *Id*. The NAIC appointed John M. Huff as the current state insurance commissioner on the FSOC. *About the Director*, MISSOURI DEPT. OF INS., FIN. INST., & PROF. REGISTRATION, http://difp.mo.gov/director.php (last visited May 17, 2013).

168. *Id.* § 5321(b)(1). Currently, S. Roy Woodall, Jr. holds the position of the independent insurance expert on FSOC. *Financial Stability Oversight Council*, U.S. DEPT. OF THE TREASURY, http://www.treasury.gov/initiatives/fsoc/about/council/Pages/roy_woodall.aspx (last visited May 17, 2013).

169. *Id.* § 5321(b)(3).

170. Definitions of "Predominantly Engaged In Financial Activities" and "Significant" Nonbank Financial Company and Bank Holding Company, 78 Fed. Reg. 20,756 (Apr. 5, 2013) (to be codified at 12 C.F.R. pt. 242), *available at* http://www.gpo.gov/fdsys/pkg/FR-2013-04-05/pdf/2013-07688.pdf.

171. DODD–FRANK ACT, *supra* note 12; 31 U.S.C. § 313(c)(1)(D).

172. *Id.* § 313(c)(1)(E).

consult with the states regarding both national and international insurance issues.[173] FIO is limited to advising on international prudential standards and not market conduct standards. The state insurance commissions continue to be the only entities with the power to regulate and negotiate on standards for consumer protections and other aspects of how the markets should operate.[174]

While FIO is to coordinate federal efforts to obtain international insurance prudential standards, it does not have the power to negotiate such agreements. Only the Treasury Secretary and the U.S. Trade Representative (USTR) have the power to negotiate binding agreements on such standards.[175] FIO's final international function is to determine when the standards within an international agreement negotiated by the Treasury Secretary and USTR will conflict with and preempt the standards established by one or more of the state insurance commissions within the United States.[176]

The Dodd–Frank Act, through the channel of international agreements, has opened up the way for uniform standards to be imposed upon the states. Congress had considered imposing such standards through the State Modernization and Regulatory Transparency Act (SMART Act).[177] Former Representative Michael Oxley (R-OH) and former Representative Richard Baker (R-LA) conceived of the SMART Act as a means of getting the states to overcome the lack of uniform regulations and the high costs of the state regulation of insurance.[178] Representative Oxley tried to model the SMART Act after those provisions in the GLBA that threatened to create a federal regulator within a fixed timeframe if the states failed to enact certain types of laws and regulations.[179] Those provisions in GLBA spurred the states to enter into reciprocity agreements that reduced the number of state licensing applications that insurers had to file.

The SMART Act, if it had been enacted, would have required the states to adopt the NAIC model laws regarding market conduct within three years or have those model acts become law at the end of the three year period automatically and preempt any contradictory laws.[180] It also would have required states to adopt the NAIC model laws governing licensing of insurers, producers, and reinsurers within two to three years

173. *Id.* § 313(c)(1)(G).

174. *See id*. § 313(k).

175. *Id*. § 314.

176. *Id.* § 313(c)(1)(C)–(D).

177. SMART ACT, *supra* note 3.

178. Press Release, House Committee on Fin. Services, Oxley Outlines Road Map to State-Based Insurance Regulatory Reform (Mar. 15, 2004).

179. *Id.*

180. SMART ACT, *supra* note 3, § 204.

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or have their laws be preempted and the NAIC laws put in their place at the end of the specified timeframe.[181] In addition, the SMART Act would have required the states to end their regulation of rates after two years.[182] The SMART Act was never even introduced into Congress as a bill because of questions raised about its constitutionality.[183]

The Dodd–Frank Act, however, does not suffer from these constitutional issues due to the Supreme Court's ruling in *Missouri v. Holland*.[184] In that case, the Supreme Court held that Congress could impose national norms on the states through its treaty power.

While the federal government is not actively seeking to use its treaty powers to impose prudential standards on the states at this time, FIO is engaged in several international initiatives to clarify prudential supervisory standards for insurance companies and insurance groups. For example, in an attempt to help convince the EU that the U.S. regulatory system provides "equivalent" protections to those provided by Solvency II, FIO has created the US–EU Insurance Dialogue among the European Commission (EC), the European Insurance and Occupational Pensions Authority (EIOPA), the UK FSA, and the state regulators to evaluate the European and U.S. systems of regulating insurance along seven factors: (1) "group supervision", (2) "capital and use of internal models", (3) "reinsurance", (4) "professional secrecy or confidentiality", (5) "financial reporting", (6) "supervisory peer reviews", and (7) "independent audits, actuarial reports and on-site regulatory examinations."[185] If the U.S. regulators are unable to convince the EU that the U.S. system is equivalent, then U.S. insurers operating in the EU will have to undergo additional supervisory reviews or standards imposed by the European insurance regulators.[186]

In addition, FIO is participating in the development of IAIS's Common Framework (ComFrame) for the supervision of global systemically important insurers (G-SIIs).[187] ComFrame seeks to promote convergence among the different supervisory approaches

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181. *Id*. §§ 301, 403, 900.

182. *Id*. at Title XVI.

183. For example, the U.S. Supreme Court has stated that Congress could not compel the states to enact or enforce a federal regulatory program and Congress imposing what insurance laws the states must enforce would potentially violate this holding. *See* New York v. United States, 505 U.S. 144, 188 (1992).

184. Missouri v. Holland, 252 U.S. 416 (1920).

185. Press Release, U.S. Dept. of the Treasury, Testimony of Federal Insurance Office (FIO) Director Michael McRaith Before the House Financial Services Subcommittee on Insurance, Housing and Community Opportunity on U.S. Insurance Sector: International Competitiveness and Jobs (May 17, 2012), *available at* http://www.treasury.gov/press-center/press-releases/Pages/tg1585.aspx [hereinafter McRaith Testimony 2012].

186. *See* SOLVENCY II, *supra* note 131, at Art. 172, 227.

187. *Id.*

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currently employed towards a global standard. ComFrame is not intended to be an enforceable international agreement or treaty but would only provide a soft law standard for supervising G-SIIs. In order to become the law in the United States, the individual states would have to enact statutes to bring their insurance laws into conformity with the ComFrame standards. As a result, FIO's main role is to work with the NAIC and the state regulators to develop a coordinated U.S. policy for the standards to be adopted by ComFrame.

Coordinating U.S. policy towards ComFrame will not be easy. In a letter dated March 26, 2013, Representative Randy Neugebauer (R-Texas) voiced the concerns of many state insurance commissioners and industry officials that the current direction of ComFrame will harm the competitiveness of U.S. insurers and impose unnecessary costs on consumers if it is implemented in the United States.[188] If the IAIS cannot arrive at a consensus regarding which insurers are G-SIIs because of U.S. concerns, then the bank-centric Financial Stability Board would probably make the decision.[189] The next draft of ComFrame is due to be completed by September 2013.[190]

While FIO's powers are limited, the provisions within the Dodd–Frank Act do go a long way to address the problems that the state insurance regulatory structure has created for achieving international insurance norms. The real test will be whether the federal authorities are willing to agree to international standards in the face of opposition from some portion of the states within the United States.

C. Systemic Risk

The Dodd–Frank Act dealt with insurance issues in several places besides its creation of FIO, although FIO has a role to play in assisting other agencies in addressing these concerns. The most obvious instance of this is the relationship between FSOC and FIO to address systemic risk concerns raised by insurance companies.

The act gave FSOC the power to manage systemic risks, including those posed by non-bank financial institutions such as insurance companies. If non-bank financial institutions are deemed to pose significant systemic risks, then a vote by two-thirds of the members of

188. Elizabeth Festa with Dave Postal, *Neugebauer to FIO: I'm Concerned About IAIS Proposals*, LIFEHEALTHPRO (Mar. 26, 2013), http://www.lifehealthpro.com/2013/03/26/neugebauer-to-fio-im-concerned-about-iais-proposal.

189. Elizabeth D. Festa, *IAIS Shows its Hand on FSB, Extends ComFrame Debate*, LIFEHEALTHPRO (Apr. 6, 2013), http://www.lifehealthpro.com/2013/04/06/iais-shows-its-hand-on-fsb-extends-comframe-debate (citing comments from Yoshi Kawai, Secretary General of the IAIS).

190. *Id.*

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FSOC can subject those institutions to supervision by the Federal Reserve.[191] Under the Dodd–Frank Act, the Federal Reserve already regulates any insurance conglomerate that is classified as either a financial holding company, a bank holding company, or a thrift holding company, such as AIG. Such firms, however, can escape the Federal Reserve's supervision if they sell off all of their banking or thrift affiliates, if they did not receive financial assistance under the Troubled Asset Relief Program (TARP), and if they are not classified as SIFIs by FSOC.[192] MetLife did just this by selling off its bank subsidiaries and obtaining the approval from the Federal Deposit Insurance Corporation and the Board of Governors of the Federal Reserve to deregister as a bank holding company.[193] In seeking deregistration, MetLife was aided by the fact that it did not receive any TARP funds. Thus, assuming that FSOC does not designate it as a SIFI, MetLife would no longer be supervised by the Federal Reserve.[194] AIG cannot escape Federal Reserve supervision because it received TARP funds.

Many insurance conglomerates would prefer to escape the regulatory reach of the Federal Reserve because they believe it to be more stringent than the functional banking, securities, and insurance regulators. For example, when MetLife failed the Federal Reserve's stress tests in March 2012, it claimed that the tests were too strict for a conglomerate that was primarily an insurance provider and that it would have passed if insurance capital adequacy standards had been applied, instead of banking capital adequacy standards.[195]

Insurance firms and state regulators have repeatedly expressed concerns over the years that if insurance regulation is moved to the federal level that it will be distorted by the "bank-centric" federal system. They have argued that insurance and banking are significantly different from each other and that regulations designed for banks do not work well for insurance companies, which have "different business models, risk profiles, and capital needs than banks."[196]

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191. DODD–FRANK ACT, *supra* note 12; 12 U.S.C. § 5323.

192. *Id.* §§ 5323, 5327(a).

193. *Press Release: MetLife, MetLife Sheds Bank Holding Company Status with Approvals from the Federal Reserve and FDIC*, METLIFE (Feb. 14, 2013), http://investor.metlife.com/phoenix.zhtml?c=121171&p=irol-newsArticle&id=1785289.

194. Although FSOC has not yet named MetLife as a SIFI, MetLife's chief executive office attempted to deter them from doing so when he testified before the House Financial Services Committee in early Mar. 2013. Danielle Douglas, *MetLife CEO Makes Case Against Being Deemed 'Systemically Important'*, WASH. POST (Mar. 7, 2013), http://articles.washingtonpost.com/2013-03-07/business/37516979_1_financial-firms-tougher-oversight-kandarian.

195. Andrew Frye & Charles Mead, *MetLife Leads Insurers Lower After Failed Fed Test*, BLOOMBERG BUSINESSWEEK (Mar. 14, 2012), http://www.businessweek.com/news/2012-03-14/metlife-leads-life-insurers-lower-as-firm-fails-fed-capital-test.

196. Nat'l Assoc. Ins. Com. & Ctr. For Ins. Policy and Research, *Government Relations Issues*

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At least in terms of its membership, FSOC is bank-centric. Six of the fifteen members are responsible for regulating some aspect of depository institutions, which include banks, thrifts, and credit unions, and five of them are voting members.[197] Only three out of the fifteen members of FSOC represent the insurance sector and only one of them is a voting member.[198] Only two out of the fifteen members regulate the securities sector and only one of them is a voting member.[199] By themselves, the five voting members from banking regulators, if they voted as a bloc, are only two votes short of the number of votes needed to designate a non-bank financial institution as a SIFI and subject to supervision by the Federal Reserve. The banking regulators do not always agree with one another and as a result, it might not be so easy to get the votes needed to classify insurance companies as SIFIs.

As noted above, the FSB will influence FSOC's decisions regarding which firms to classify as SIFIs and the prudential standards that will be imposed on any entities designated as SIFIs. The FSB, like FSOC, tends to be dominated by banking supervisors.[200] As a result, state insurance commissioners and U.S. insurance industry officials are concerned that the FSB's influence will cause the FSOC to use inappropriate banking standards for determining which insurance firms to classify as SIFIs and apply capital adequacy standards based on the Basel III rules created for banking conglomerates rather than standards that better take into account the unique business features of insurance.[201] The U.S. representatives on the FSB are the Federal Reserve, the Treasury Department, and the Securities and Exchange Commission.[202] FIO's input on the FSB's SIFIs deliberations would be through the

Brief, Federal Reserve Supervision and Basel III: Insurer Impact, http://www.naic.org/documents/topics_fed_and_basel_3.pdf; *see also*, Elizabeth Festa, *With IAIS in Town, Focus is on Avoiding Bank-centric Standards*, LIFEHEATHPRO (Oct. 4, 2012), http://www.lifehealthpro.com/2012/10/04/with-iais-in-town-focus-is-on-avoiding-bank-centri; *Examining the Impact of Proposed Rules to Implement Basel III Capital Standards: Hearing Before the H. Subcomm. on Ins., Hous. and Cmty. Opportunity of the H. Comm. on Fin. Servs*, 112th Cong. 2–3 (Nov. 29, 2012) (statement of Kevin M. McCarty, President of NAIC, and Commissioner of the Florida Office of Insurance Regulation); Fed. Advisory Board on Ins., Meeting Minutes (Nov. 14, 2012) at 8, *available at* http://www.treasury.gov/about/organizational-structure/offices/Documents/11-14%20faci%20min%20fin.pdf [hereinafter FACI Nov. 2012 Meeting].

197. *See* DODD–FRANK ACT, *supra* note 12; 12 U.S.C. §§ 5321(b)(1)–(2).

198. *See id.*

199. *See id.*

200. *Links to FSB members*, FINANCIAL STABILITY BOARD, http://www.financialstabilityboard.org/members/links.htm (last visited May 17, 2013) [hereinafter FSB Membership].

201. Elizabeth Festa, *With IAIS in Town, Focus is on Avoiding Bank-centric Standards*, LIFEHEALTHPRO (Oct. 4, 2012), http://www.lifehealthpro.com/2012/10/04/with-iais-in-town-focus-is-on-avoiding-bank-centri.

202. FSB Membership, *supra* note 200.

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representative from the Treasury Department or through FIO's influence on the IAIS, in which FIO is a member. Thus, FIO can only indirectly affect the domestic and international determinations about which insurance companies pose systemic risks.

IV. FIO STUDY ON MODERNIZING INSURANCE REGULATION

The final task that the Dodd–Frank Act assigned to FIO was to produce a report on what the United States should do to modernize insurance regulation within the United States.[203] This report was due in January of 2012. In March 2013, FIO's Director claimed that FIO would finally release its modernization report by July of 2013, which would be eighteen months late. FIO's Director made his comment in the wake of criticism from the House Financial Services Committee. On February 15, 2013, the House Financial Services Committee in its Oversight Plan had chided FIO for missing the deadline for this report and three other reports required under the Dodd–Frank Act and urged them to release them "without further delay."[204]

The Dodd–Frank Act specified ten factors that the modernization report should cover, including, among other things, systemic risk regulation, consumer protection regulation, international regulation, the level of uniformity of state insurance laws, and the need for federal insurance regulation, as well as any other topics that the Director of FIO deemed appropriate.[205] Not surprisingly, members of the insurance industry and the states are extremely interested in what recommendations FIO will make in this report, particularly with regard to whether the federal government should become more directly involved in insurance regulation.

Given the limited scope of this Article, it is not possible to discuss what recommendations FIO might make on all ten factors that Congress would like it to address. As a result, this Article will focus on the issue of whether FIO will recommend that Congress enact a law creating an optional federal charter for insurance or should become more directly involved in the regulation of insurance by other means, such as mandating minimum uniform standards or laws in particular areas of insurance. Under an optional federal charter for insurance, insurance companies would have had the same option that banks now enjoy—the right to be chartered or licensed either at the state or at the federal level. The primary supporters of an optional federal charter were the American

203. DODD–FRANK ACT, *supra* note 12; 31 U.S.C. § 313.

204. H. COMM. ON FIN. SERVICES, 113TH CONG., OVERSIGHT PLAN 16 (Feb. 15, 2013), *available at* http://financialservices.house.gov/about/oversight.htm [hereinafter OVERSIGHT PLAN].

205. *Id.*

https://scholarship.law.uc.edu/uclr/vol81/iss2/6

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Council of Life Insurance (ACLI), the American Bankers Insurance Association (ABIA), and the American Insurance Association (AIA), which had been lobbying Congress to enact a federal insurance charter scheme since 2001.[206] Financial conglomerates with significant businesses in the banking area, which predisposes them to favor the duel banking system over the state-based insurance regulatory regime, have substantial influence within the ACLI, ABIA, and AIA.

Several factors will influence the ultimate recommendations made by FIO, including the current staff and advisors to FIO, the comments received in response to the notice seeking public input on how the United States should modernize its insurance regulations, and lobbying of government officials by insurance firms and trade associations. Each one of these will be analyzed in turn.

A. Employees and Advisors

Given the lack of any federal agency previously dealing with insurance, it is not surprising that the majority of the officials and advisors appointed to FIO and to the Federal Advisory Committee on Insurance (FACI) come from industry or from state regulators. The current Director for FIO is Michael T. McRaith, who previously served as the Director for the Illinois Department of Insurance from 2005 to 2011.[207] Before managing the Illinois Department of Insurance, he worked as an attorney representing financial institutions, including insurers, for fifteen years.[208] During his first eighteen months in office, Director McRaith has provided some indications of how he envisions FIO's role and the role of the federal government more generally in the regulation of insurance. He has predominately focused on the ability of FIO to represent the United States internationally, particularly with regard to developing international standards for regulating systemically important insurers and solvency standards.[209]

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206. AM. BANKERS INS. ASS'N, COMPARISON OF OPTIONAL FEDERAL INSURANCE CHARTER BILLS (Feb. 20, 2002), http://www.aba.com/ABIA/Pages/Issue_RM.aspx (click on the link "Comparison of Optional Federal Charter Bills (3-1-02)" under the heading Testimony); ACLI Draft Proposal on Federal Insurance Charter, LEBOEUF, LAMB, GREENE & MACRAE LLP (Apr. 20, 2001) (on file with author); Comparison of ACLI, ABIA and AIA Federal Insurance Charter/Licensing Proposals, LEBOEUF, LAMB, GREENE & MACRAE LLP (July 30, 2001) (on file with author).

207. Michael T. McRaith, Financial Stability Oversight Council, U.S. Dept. of the Treasury, http://www.treasury.gov/initiatives/fsoc/about/council/Pages/michael_mcraith.aspx (last visited Apr. 30, 2013) [hereinafter MCRAITH BIOGRAPHY]; Kevin Lyons, *Illinois Insurance Director Picked to Lead New Federal Insurance Office*, INSURANCEQUOTES.COM, http://www.insurancequotes.com/federal-insurance-office/; *McRaith to Lead New Federal Insurance Office*., INS. J. (Mar. 18, 2011), http://www.insurancejournal.com/news/national/2011/03/18/190630.htm.

208. MCRAITH BIOGRAPHY, *supra* note 207.

209. Press Release, U.S. Dept. of the Treasury, Written Testimony of Director of the Federal

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While Director McRaith has commented that the FIO report will address issues regarding the possible abuses of captive insurers and special purpose vehicles in reserving and risk transfer, he has not indicated whether the report would support federal regulation to correct such abuses.[210] In addition, he has not made any specific comments advocating federal regulation of insurance. He has repeatedly emphasized that "the states remain the primary regulators of the insurance sector in the United States" and that "FIO is not a regulator."[211] While he was the Illinois Insurance Director, however, he was on record as opposing an optional federal charter.[212] At that time, he had predicted that an optional federal charter would not happen.[213]

While Director McRaith might not favor an optional federal charter, it does not mean that he would be completely opposed to all forms of federal regulation. For example, he might support the creation of a National Association of Registered Agents and Brokers. In the past three years, Senator John Tester (D-Montana), Senator Mike Johanns (R-Nebraska), Representative Randy Neugebauer (R-Texas), and Representative David Scott (D-Georgia) have revived the idea.[214] Senators Tester and Johanns introduced into the Senate the National Association of Registered Agents and Brokers Reform Act originally in 2012 and re-introduced it in 2013.[215] Representatives Neugebauer and Scott introduced a similar bill in the House, first in 2011 and then again in 2013.[216] NAIC supports the 2013 versions of these bills.[217]

Insurance Office Michael T. McRaith (Oct. 25, 2011), http://www.treasury.gov/press-center/press-releases/Pages/tg1339.aspx; Press Release, U.S. Dept. of the Treasury, Remarks by Federal Insurance Office Director Michael McRaith at Property/Casualty Insurance Joint Forum (Jan. 10, 2012), http://www.treasury.gov/press-center/press-releases/Pages/tg1393.aspx [hereinafter McRaith Remarks]; McRaith Testimony 2012, *supra* note 185.

210. Global Assoc. of Risk Professionals, Risk News & Resources, *Debate Over Fed, State, International Rules Intensifies*, (Apr. 1, 2013), http://www.garp.org/risk-news-and-resources/risk-headlines/story.aspx?newsid=61078 [hereinafter GARP].

211. McRaith Testimony 2012, *supra* note 185; McRaith Remarks, *supra* note 209.

212. Laura Mazzuca Toops, *Optional Federal Charter Won't Happen, Illinois Top Regulator Predicts*, PROPERTYCASUALTY360.COM (Oct. 23, 2009), http://www.propertycasualty360.com/2009/10/23/optional-federal-charter--wont-happen-ill-top-regulator-predicts-.

213. *Id.*

214. Hall, *supra* note 37; GARP, *supra* note 210. Representative Scott was the first to attempt to revive the NARAB concept as he introduced the National Association of Registered Agents and Brokers Reform Act of 2008. *See* govTrack.com NARAB 2008, *supra* note 54.

215. National Association of Registered Agents and Brokers Reform Act of 2011, H.R. 1112, 112th Cong, 1st Sess. (Mar. 16, 2011), *available at* http://www.govtrack.us/congress/bills/112/hr1112/text; National Association of Registered Agents and Brokers Reform Act of 2013, H.R. 1155, 113th Cong, 1st Sess., (Mar. 12, 2013), *available at* http:// http://www.govtrack.us/congress/bills/113/hr1064/text.

216. National Association of Registered Agents and Brokers Reform Act of 2012, S. 2342, 112th Cong, 2nd Sess., (Apr. 24,, 2012), *available at* http://www.govtrack.us/congress/bills/112/s2342/text;

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Director McRaith's views are not the only ones that are relevant. FACI advises FIO in order to help FIO carry out its duties. The members of FACI could provide input on what areas of insurance regulation need to be modernized. As of April 2013, the members of FACI include Christopher Mansfield, senior vice president and general counsel of Liberty Mutual Group; John Degnan, senior advisor to the CEO of the Chubb Corp. and the company's former COO; Brian Duperreault, president and CEO of the Marsh & McLennan Companies; Loretta Fuller, CEO of Insurance Solutions Associates; Sean McGovern, a director and general counsel of Lloyd's North America; David "Birny" Birnbaum, an economist and executive director of the Center for Economic Justice; Michael E. Sproule, New York Life Insurance Co. executive vice president and CFO; Scott E. Harrington, a professor in the Health Care Management and Insurance and Risk Management departments at the Wharton School, University of Pennsylvania; Benjamin Lawsky, New York superintendent of Financial Services; Thomas Leonardi, Connecticut insurance commissioner; Michael Consedine, Pennsylvania insurance commissioner; Jacqueline Cunningham, Virginia insurance commissioner; William White, District of Columbia insurance commissioner; Monica Lindeen, Montana commissioner of Securities and Insurance and state auditor; and Scott Kipper, Nevada insurance commissioner.[218]

Given the membership of FACI, it is unlikely that it will advocate significant changes to the insurance regulatory structure, such as the creation of an optional federal charter for insurance. Seven of the fifteen members are from state regulators, who generally are opposed to any federal efforts to regulate insurance. Six of the fifteen are industry representatives, who tend to have more mixed views on whether a federal charter would be beneficial.[219] Only one representative, Birny Birnbaum, represents the interests of consumers and only one representative, Scott Harrington, is an academic.[220]

National Association of Registered Agents and Brokers Reform Act of 2013, S. 534, 113th Cong, 1st Sess., (Mar. 12, 2013), *available at* http://www.govtrack.us/congress/bills/113/s534/text. In the 112th Congress, the House passed the 2011 version but the Senate failed to pass its version and so the bill died, which is why the bills had to be re-introduced in the 113th Congress. Hall, *supra* note 37.

217. *Press Release: NAIC Testifies Before Congress in Support of Streamlined Producer Licensing Legislation*, NAT'L ASSOC. INS. COM. & CTR. FOR INS. POLICY AND RESEARCH (Mar. 19, 2013), http://www.naic.org/Releases/2013_docs/naic_testifies_before_congress_in_support_streamlined_producer_licensing.htm.

218. *FACI Members*, U.S. DEPT. OF THE TREASURY, http://www.treasury.gov/about/organizational-structure/offices/pages/faci_members.aspx (last visited May 17, 2013).

219. *See id.*

220. *Id.*

Only two of the fifteen members of FACI, Scott Harrington and Sean McGovern, submitted comments in response to FIO's request for comments as FIO began work on its modernization report.[221] Sean McGovern of Lloyd's did not indicate in his comment letter whether Lloyd's or he favored an optional federal charter.[222] Prior to his appointment to FACI, Sean McGovern had stated that Lloyd's was not "pushing for a federal charter."[223] Dr. Harrington in his comment letter does not argue for the creation of an optional federal charter for insurance.[224] Instead, he points out that the states did a reasonable job of regulating the insurance industry during the financial crisis, that an optional federal charter regime would entail large costs for uncertain benefits, and would increase the likelihood of the federal government bailing out too big to fail insurance companies in the future.[225] These views are consistent with his prior writings on the subject. Prior to his appointment on FACI, Scott Harrington, published two articles that advocated a conservative approach to any regulatory changes, arguing that the differences between banking and insurance, the relatively low systemic risks posed by insurance, and the strong market discipline in the area of insurance cautioned against any major changes in insurance regulation.[226]

In addition, while Christopher Mansfield of Liberty Mutual did not submit a comment letter, Paul Mattera, the Senior Vice President and Chief Public Affairs Officer of Liberty Mutual, did.[227] It is likely that Mr. Mansfield's views on an optional federal charter do not differ greatly from those of his firm. Paul Mattera in the comment letter that he wrote on behalf of Liberty Mutual did support the creation of an optional federal charter system, although he warned against "dual regulation where financial and market regulation are divided."[228]

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221. Scott Harrington, Response to Request for Public Input on the Report to Congress on How to Modernize and Improve the System of Insurance Regulation in the United States (Dec. 19, 2011) [hereinafter Harrington Response]; Sean McGovern, Response to Request for Public Input on the Report to Congress on How to Modernize and Improve the System of Insurance Regulation in the United States (Dec. 16, 2011).

222. McGovern, *supra* note 221.

223. Charles E. Boyle, *Lloyd's New Director of North America, McGovern, Navigates Turbulent Waters*, INS. J. (Nov. 14, 2010), http://www.insurancejournal.com/magazines/features/2010/11/14/160489.htm.

224. Harrington Response, *supra* note 221, at 3–4.

225. *Id.*

226. Scott E. Harrington, *The Financial Crisis, Systemic Risk, and the Future of Insurance Regulation*, 76 J. RISK & INS. 785 (2009); Scott E. Harrington, *Insurance Regulation and the Dodd–Frank Act* (Networks Fin. Inst., Working Paper, 2011), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1783904.

227. Paul Mattera, Response to Request for Public Input on the Report to Congress on How to Modernize and Improve the System of Insurance Regulation in the United States (Dec. 16, 2011).

228. *Id.* at 2.

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Two of the four other industry representatives on FACI have publicly stated views on whether an optional federal charter would be desirable. Brian Duperreault of Marsh & McLennan Companies commented in 2010 that he no longer supported an optional federal charter for insurance as it would just add one more regulator to the existing 50 state regulators and probably would not promote efficiency.[229] John Degnan of Chubb Corp., however, has voiced his support for an optional federal charter in the past and has not made any public statements that indicate that he has changed his mind. In 2009, Mr. Degnan stated, "Our industry would operate much more efficiently without the constant changes to products, prices and practices foisted upon us by 50 separate state legislatures and 50 regulators,"[230] In addition, while Michael Sproule has not personally made any public statements regarding an optional federal charter, his firm, New York Life Insurance Co., was one of 135 companies that formed the Optional Federal Charter Coalition to lobby for an optional federal charter prior to the financial crisis.[231]

The sole consumer representative on FACI, Birny Birnbaum, also opposes an optional federal charter for insurance because most proposals advocating such a charter prior to the financial crisis favored deregulation and were "very anti-consumer."[232] He, however, was not opposed to all federal regulatory schemes for insurance but he had not seen one proposed that would offer consumers better protections than what they were getting from the states.[233]

Thus, only three members or their organizations are on record as supporting a federal charter and ten are generally opposed to the idea. As a result, it seems unlikely, given that most of the members of FACI are opposed to an optional federal charter, that FACI would be advocating for FIO to recommend the creation of an optional federal charter.

Opposition to creating a federal charter regime does not mean that the members of FACI are opposed to all forms of federal regulation. Some

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229. Mark E. Ruquet, *Will More Regulation Solve Every Problem?*, PROPERTYCASAULTY360.COM (May 17, 2010), http://m.propertycasualty360.com/2010/05/17/will-more-regulation.

230. Bill Keneally, *Regulatory Issues Impel Advance on the Hill*, INS. NETWORKING NEWS (Jan. 1, 2009), http://www.insurancenetworking.com/issues/2008_57/insurance_financial_services_meltdown_legislation_regulations11653-1.html?pg=2.

231. Stanford Group Company, *Insurance Regulation Reform: The Optional Federal Charter*, WASHINGTON FINANCIAL SERVICES BULLETIN (June 27, 2007), http://www.bipac.net/afc/FINS0627_ofc.pdf.

232. *Consumer Advocates Wary of Federal Insurance Regulation Plans*, INS. J. Apr. 16, 2009, http://www.insurancejournal.com/news/national/2009/04/16/99590.htm.

233. *Id.*

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comments and actions taken by FACI in the past year indicate that it might favor some instances of federal regulation.

In its inaugural meeting on March 30, 2012, FACI created two subcommittees: one, Subcommittee I, to focus on the impact of national and international demographic and socio-economic developments "on affordability, accessibility and capacity," and another, Subcommittee II, to focus on "the key principles, objectives or concerns that promote the supervisory balance essential to insurance firms looking to expand into an emerging market" and the effect of national and international demographic and socio-economic developments on those principles.[234] FACI created a third subcommittee, Subcommittee III, at its Aug. 6, 2012 meeting to focus on the development of international standards.[235] In the Nov. 2012 meeting of FACI, John Degnan commented that the release of the FIO report on insurance modernization would help the subcommittees do their work.[236] In addition in the Nov. 2012 meeting, some members of FACI Subcommittee II commented that the lack of a federal regulator hampered the competitiveness of U.S. firms operating outside of the United States.[237] FACI decided to delegate an examination of whether the U.S. state-based system harmed U.S. firms' competitiveness to Subcommittee III.[238] FACI also debated at its Nov. 2012 meeting whether a single solvency standard was appropriate and expressed doubts that it was possible to create such a standard within the United States given federalism and the fact that all states do not accept NAIC recommendations.[239]

The proposed 2014 budget released by the Office of Management and Budget in April 2013 contains language that suggests FIO may be positioning itself to take on some form of regulatory role in the future. The budget contained a section entitled, "Streamlined Insurance Sector Regulation", which discussed FIO's activities.[240] It also stated, "The FIO was created, in part, to streamline what is currently a decentralized

234. Fed. Advisory Board on Ins., Meeting Minutes (Mar. 30, 2012) at 2–3, http://www.treasury.gov/about/organizational-structure/offices/Pages/Federal-Insurance.aspx (follow link for "Committees/Board/Commissions", click on pdf for Mar. 30, 2012 Minutes); Fed. Advisory Board on Ins., Meeting Minutes (Aug. 6, 2012) at 4–6, http://www.treasury.gov/about/organizational-structure/offices/Pages/Federal-Insurance.aspx (follow link for "Committees/Board/Commissions", click on pdf for Aug. 6, 2012 Minutes) [hereinafter FACI Aug. 2012 Meeting]; FACI Nov. 2012 Meeting, *supra* note 195, at 7–12.

235. FACI Aug. 2012 Meeting, *supra* note 234, at 6.

236. FACI Nov. 2012 Meeting, *supra* note 196, at 8.

237. *Id.* at 10.

238. *Id.*

239. *Id.*

240. Office of Management and Budget, Fiscal Year 2014 Analytical Perspectives Budget of the U.S. Government (U.S. Govt. Printing Office: 2013), *available at* http://www.whitehouse.gov/sites/default/files/omb/budget/fy2014/assets/spec.pdf.

regulatory regime."[241]

The language from the proposed 2014 budget and the comments at the Nov. 2012 FACI meeting indicate that FIO may be considering some types of federal regulation, particularly in the area of solvency regulation. Creating an optional federal charter, however, would not be necessary to achieve a federal standard for solvency regulation. As previously noted, the federal government through a treaty or international agreement could mandate that the states require insurance companies meet certain uniform capital adequacy standards.[242] It is worth noting that in none of the publicly released minutes do members of FACI make specific recommendations as to what positions FIO should take in its modernization of insurance regulation report.

B. Comments

On October 17, 2011, FIO published a notice seeking public input on how to modernize insurance regulation in the United States for its report on the topic, which was required by the Dodd–Frank Act.[243] FIO only received 144 comments, which is a far cry from the more than 17,000 comments that were submitted on the Volker Rule.[244] Not surprisingly, only thirty comments came from the general public and the remainder of the comments came from either insurance or other financial services businesses or from industry or consumer associations.[245] Comments from the financial services firms, the industry associations, and consumer groups tended to be more detailed and more thoughtful than those provided by individuals. A few of the comments from businesses seemed designed to sell FIO some sort of technology to help it with its general operations rather than addressing the issues raised in the Federal Registrar notice. Some of the comments from insurance agents or insurance agents' associations seemed to have been based on a standard or model comment letter as they contained similar language and covered the same range of issues.

A majority of the comments addressed the issue of whether the

241. *Id.* at 27.

242. *See* discussion *infra* accompanying notes 175–84.

243. Public Input on the Report to Congress on How to Modernize and Improve the System of Insurance Regulation in the United States, 76 Fed. Reg. 64174 (Oct. 17, 2011).

244. Phil Mattingly, *Volume of Volcker Rule Comments Was No Surprise, Regulators Say*, BLOOMBERG BUSINESSWEEK (Mar. 13, 2012), http://www.businessweek.com/news/2012-03-13/volume-of-volcker-rule-comments-was-no-surprise-regulators-say.

245. The comments may be accessed via the Federal Insurance Office's webpage on the U.S. Department of the Treasury's site. U.S. Department of the Treasury, Federal Insurance Office, About, Organizational Structure, Resources, http://www.treasury.gov/about/organizational-structure/offices/Pages/Federal-Insurance.aspx (follow "Electronic Comments" link).

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federal government should be involved in some aspect of insurance regulation, and a significant number of those comments specifically discussed whether the United States should create an optional federal charter for insurance. Sixty-two comment letters directly address the issue of an optional federal charter. Of those comments, forty-one opposed the idea, three expressed neutral views on the matter, and eighteen supported the idea.

Those most vested in the current structure, such as state insurance regulators or state groups of insurance agents, comprised the bulk of comments against the optional federal charter proposal. State regulators will lose some of their power and revenue if companies are allowed to choose whether they will be regulated by state or federal regulators. Insurance agents will lose because they will face increased competition as the barriers of entry into their marketplaces will be lower.

C. Lobbying of Government Officials

The insurance industry has never been one to skimp on spending for lobbying.[246] The insurance industry spent more on lobbying between 1998 and 2012 than any other part of the financial services and real estate sector.[247] The insurance industry spent over $159 million in 2011, or one-third of the over $482 million total that the finance, insurance, and real estate sector spent.[248] The preliminary numbers spent on lobbying for 2012 indicate that the amounts spent by the insurance industry declined slightly to about $151.7 million, although the amounts spent by the entire finance, insurance, and real estate sector rose to about $482.2 million.[249] The 2012 numbers may be revised in the future. The amount of lobbying that the finance, insurance, and real estate sector has engaged in over the past fourteen years has more than doubled, from about $207.9 million in 1998 to about $482.2 million in 2012.[250]

246. *See Lobbying: Top Industries (2012)*, CENTER RESPONSIVE POL. (2012), http://www.opensecrets.org/lobby/top.php?indexType=i (last visited Mar. 18, 2013).

247. *Lobbying: Finance, Insurance & Real Estate Statistics (1998–2012)*, CENTER RESPONSIVE POL, (data chart from 1998–2012 on file with author), *available at* http://www.opensecrets.org/lobby/index.php (online database used to access years data from years 1998–2012).

248. *Id.*

249. *Id.*

250. *Id.*

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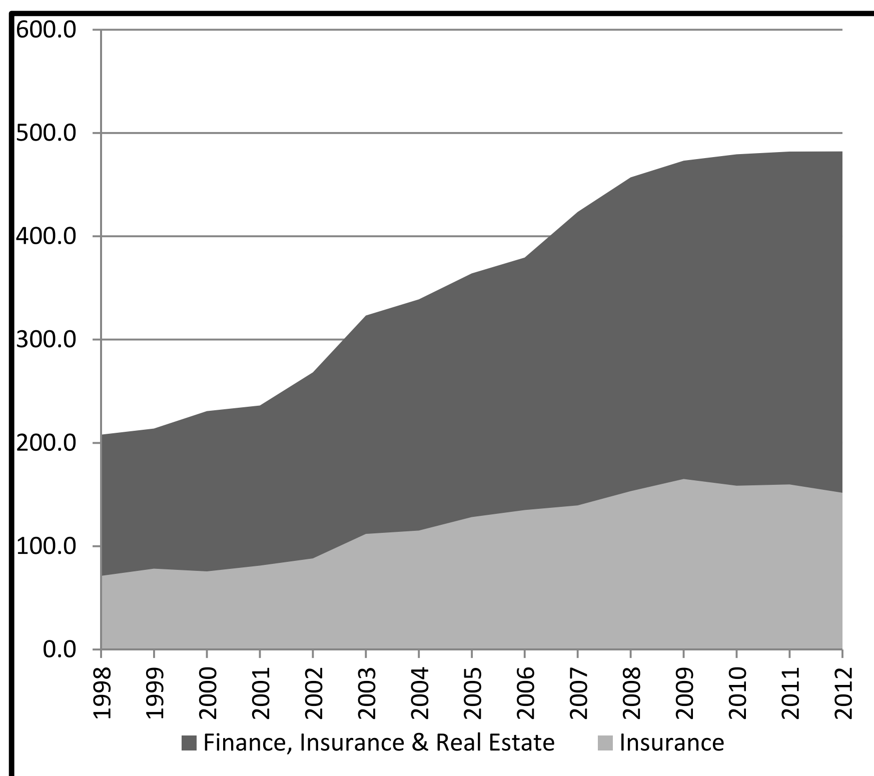
Fig. 2: Annual Amounts Spent on Lobbying by Insurance Industry and the Finance, Insurance, & Real Estate Sector[251]



While the records of the Treasury Department, the Federal Reserve, the FDIC, the SEC, and the CFTC show which representatives of NAIC, other insurance associations, and insurance firms met with the highest ranking officials in each agency to discuss the regulations that they are responsible for developing under the Dodd–Frank Act, these agencies' records do not go down to the office level. As a result, no public information exists about the people or groups who met with FIO Director McRaith or his staff. Given that FIO is responsible for the report, the most effective lobbying would have been done through meetings with FIO Director McRaith and the other officials within FIO. More senior government officials generally would not involve themselves in the details of the report, although they might influence some of the general principles behind the recommendations. As a result, it is difficult to determine if proponents or opponents of an optional

251. *Id.*

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federal charter scheme have lobbied FIO the most.

V. CONCLUSIONS

The Dodd–Frank Act gives the federal government the tools to make progress on uniform, international insurance prudential standards as well as standards for regulating SIFIs that would cover the largest insurance groups. It is doubtful, however, that the Treasury Department and USTR will be seeking to negotiate any binding international agreements on insurance prudential standards in the next few years. As a result, FIO represents only incremental progress on the international standards front.

In the Dodd–Frank Act, Congress refused to make any major changes to domestic insurance regulation and instead, attempted to mollify public concerns about insurance regulation by requesting FIO to study the matter and report back to Congress with recommendations. FIO, however, faces strong pressures from state regulators, Republican members of Congress who oppose further expansions of federal powers, and some members of the insurance industry who benefit from the current state-based system, to not significantly change the current regulatory structure for insurance.

Even if FIO were to recommend significant changes to insurance regulation such as creating an optional federal charter, FIO lacks the power to implement them. Such changes would require Congress to enact the appropriate legislation to do so. In the current political climate, which is dominated by concerns about the national debt, Congress does not consider making substantial changes to insurance regulation a priority. For example, the Oversight Plan for the House Committee on Financial Services does not mention insurance regulatory changes until page 16 of the 23 page plan.[252]

FIO also might be concerned about damaging its relationships with the state insurance regulators and certain parts of the insurance industry if it recommends significant levels of federal regulation. Such forces could use their lobbying power to persuade Congress to limit FIO's budget and undermine its ability to perform the functions assigned to it by the Dodd–Frank Act.[253]

Given these factors, FIO's report will likely adopt a conservative

252. OVERSIGHT PLAN, *supra* note 204, at 16.

253. Something similar happened to the SEC in the 1990s. At that time, industry groups persuaded Congress to restrict the SEC's budget, which hampered the agency's ability to enforce the securities laws and discouraged it from implementing more stringent investor protections. Elizabeth F. Brown, *E Pluribus Unum—Out of Many, One: Why the United States Needs a Single Financial Services Agency*, 14 U. MIAMI BUS. L. R. 1, 51 (2005).

approach that advocates incremental changes. Nevertheless, by giving the federal government the power to negotiate international agreements on insurance prudential standards and by creating FIO, the Dodd–Frank Act has established mechanisms to put constant pressure on state insurance regulators to improve both domestic and international insurance regulatory standards.

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https://scholarship.law.uc.edu/uclr/vol81/iss2/6