

## **“Why the U.S. Federal Insurance Office Regulatory Role Will Soon Expand and the Impact on Captives”**

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### **Article Excerpt:**

Between September 2011 and January 2012 the first two reports are due from the new Federal Insurance Office (the “FIO”) created by the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act”). Other reports are coming from the Financial Stability Oversight Council (the “FSOC”) also created by the Dodd-Frank Act with responsibility impacting segments of the insurance industry . These reports will almost certainly lay the foundation for expanded federal regulation of insurance. Barriers to participation in captives may eventually increase. Participating in the response to these reports is needed by the captive industry to make sure regulators take into account the size and complexity of a captive when applying capital and governance requirements.

### **Full Article:**

The Dodd-Frank Act’s implications for the insurance industry have been widely reported. It created the Federal Insurance Office (FIO), the first ever U.S. federal agency specifically established to oversee the insurance industry. This follows the European Union’s lead of establishing an EU level regulatory authority over its 27 member states in response to the global financial crisis.

Preservation of state based insurance regulation has been heavily debated since 1945 when the US Congress passed the McCarran-Ferguson Act ceding insurance regulation to the states. Every decade since 1945 Congress has conducted investigations to assess whether the states were regulating insurance adequately. A 1958 report found “state regulation lacking, incapable of dealing with interstate and international issues, and unwilling or unable to ‘bring the blessings of competition.’”<sup>1</sup> While the EU initiatives including Solvency II and ORCA may have paved the way for creation of the FIO in the US, it was inevitable that self-regulatory organizations like the National Association of Insurance Commissioners would prove insufficient to address the deficiencies of the state-based insurance regulatory system.

The new FIO office is part of the expanded Federal Reserve regulatory regime enabled by the Dodd-Frank Act designed to:

- increase consumer protections,
- end “too big to fail” bailouts,
- create an advanced warning system,
- increase transparency and accountability of exotic instruments,
- improve regulatory enforcement, and
- if you read the fine print, increase US global competitiveness (although it seems an oxymoron to suggest increased regulations can achieve this).

The Senate summary on the Dodd-Frank Act states the FIO “... will serve as the uniform, national voice on insurance matters for the United States on the international insurance stage.”<sup>2</sup>

Many believe this is a huge step in the right direction, including Ed Royce, Republican Representative from California. Mr. Royce told risk managers attending the June 2011 Risk & Insurance Management Society annual RIMS on the Hill legislative conference, that in order to compete internationally, the U.S. insurance industry needs to have a voice at the international level. “Your industry does not have a seat at the table,” said Rep. Royce, adding that he hoped FIO would help change that. /<sup>3</sup>

The FIO director is appointed by the Secretary of the Treasury. Mr Royce shared with RIMS attendees that the first FIO Director, Michael McRaith, “understands the market.” /<sup>3</sup>

As detailed below, the FIO was given express pre-emptive regulatory power on international insurance matters by the Dodd-Frank Act. The FIO is also charged with facilitating state regulatory uniformity.

Specific sections of the Dodd-Frank Act amending Title 31 of the United States Code direct the FIO to issue a series of reports on the insurance industry by these deadlines:

- September 30, 2011, the 1<sup>st</sup> State of the US General Insurance Industry annual report
- September 30, 2012, the 1<sup>st</sup> State of the US and Global Reinsurance Market annual report
- January 1, 2013, the 1<sup>st</sup> Impact of Non-admitted and Reinsurance Reform Act of 2010 on ability of state regulators to access reinsurance information.

Another section of the act, section 313 (p), gives an estimated date of January 1, 2012, for the FIO to issue a study and report to Congress on how to modernize and improve the system of insurance regulation in the US. ***It is this FIO report to Congress due by January 2012 that will have the most sweeping impact on the extent and timing of a shift from state regulation to expanded federal regulation of the insurance industry.***

This little known report, when issued, will most likely heavily dilute the widely held view that section 313 (j), the “Savings Provision,” and subsection (k) titled “Retention of Existing State Regulatory Authority,” assure the FIO was not created as a step toward pre-empting state regulatory authority of insurance companies. Regarding captives, it will be very important to respond to these reports to make sure principles of proportionality allow regulators to consider the size and complexity of a captive when applying capital and government requirements. Experts are cautioning many EU captives may have to rethink the viability of company-owned insurers under Solvency II going into effect in 2013, and may have to increase the amount of capital they hold. /<sup>4</sup> The US captive industry could gain a competitive advantage by actively participating in the coming FIO report discussion.

Other language in the portions of the Dodd-Frank Act applicable to the FIO clearly reflect an understanding that over time, reducing state roles and consolidating insurance regulation at the federal level will improve the US insurance industry’s global competitiveness. If you read the text of the Dodd-Frank Act’s provisions impacting insurance, they clearly express that the US Congress recognizes uniformity of rules, avoidance of double premium taxation, and efficiency of reporting requirements are important to US competitiveness and in consumers best interest.

In all likelihood both sides of the isle will agree uniformity of rules, reduced state regulation, and expanding the FIO role could help US insurers compete. Whether this actually proves to be the case is uncertain.

The FIO report due around the end of 2011 or early in 2012 should provide evidentiary ammunition for Congress to take overt steps into federal regulation of the insurance industry.

This FIO report is specifically directed to update Congress on these wide reaching areas:

- Identify gaps in state regulations;
- Evaluate the adequacy of capital reserves to meet expected liquidity requirements for the scope and duration of risks insured;
- Explain the degree of national uniformity of state regulations;
- Address the degree of international coordination on insurance regulation (the act elsewhere gives the FIO power to enter into Coverage Agreements with non-US jurisdictions that expressly do pre-empt inconsistent state rules and regulations);
- Identify potential costs and benefits of federal regulation of insurance;
- Discuss the feasibility of regulating certain lines of insurance at the federal level while leaving regulation of other lines to the states;
- Assess the feasibility of a federal regulator to provide robust consumer protection for policy holders.

The FIO's main stated objectives are designated in section 502 of the Dodd-Frank Act. To summarize, they are:

1. to monitor all aspects of the insurance industry;
2. to recommend what insurers they want subjected to the new non-bank financial company regulations;
3. to determine when state measures are pre-empted; and
4. to perform other related duties as assigned by the Secretary of the Treasury.

The FIO now has jurisdiction over all lines of insurance except health insurance, long-term care insurance (except to the extent part of life and annuity contracts), and crop insurance.

Regarding potential new reporting requirements impacting operating efficiency, section 313 (e) allows new data and information reporting to be required of insurers or any affiliate if the FIO director desires information not already available from other agencies or the state regulators. The FIO is to decide who qualifies as small insurers exempt from any increased reporting. They may follow some states lead and exempt companies with less than \$1 million in annual premiums. Perhaps they will follow the IRS 831 (b) lead and exempt insurance companies with \$1.2 million or less in annual premiums. We will know soon.

Section 313 (f) specifically addresses the FIO director's duty to monitor for and preempt state measures determined to result in less favorable treatment of a non-US insurer domiciled in a foreign jurisdiction and subject to a covered agreement if inconsistent with that covered agreement. The FIO is empowered to enter into such covered agreements. This should be an area of interesting developments next year.

State Based Insurance Reform is addressed in Title V, subtitle B, of that portion of the Dodd-Frank Act known as the Federal Insurance Office Act of 2010. Section 511 says subtitle B should be cited as the "Nonadmitted and Reinsurance Reform Act of 2010," and it is effective 12 months after enactment of the Dodd-Frank Act. Most provisions in these sections of this legislation aim to prevent conflicts between states and overlapping duplicate reporting or taxes. They lend further evidence of the long-

term intent to create more uniformity and efficiency of regulation between the states through the NAIC and eventually expand the FIO's rule making and regulatory power and authority while decreasing state involvement.

The FSOC will also likely be making recommendation to the states and NAIC to implement new and heightened financial standards, potentially impacting insurance investment programs and reporting.

## **Summary**

The FIO and FSOC reports coming later this year and next will lay the foundational arguments for expanded federal regulation of the insurance industry well beyond international insurance coverage agreements. Given the advisory role of the FIO director to the FSOC, any important initiatives of the FIO will likely find support within FSOC pronouncements making them almost certain to gain needed legislative support in Congress to expand FIOs official regulatory jurisdiction even over opposition of states. As long as state revenue streams are protected, this transition from state to federal regulation of insurance could occur more quickly than people suspect; especially if economic conditions do not dramatically improve since many states are experiencing budget pressure and looking for additional staff reduction opportunities. If state competition for insurance business declines, barriers to participation in captives could increase. Participating in the response to these reports by the captive industry is essential to prevent over-regulation, and to explore the opportunity to streamline captive regulations and make the US a more competitive jurisdiction. Taking advantage of increased competition amongst domiciles for new business may also be indicated to protect against captive formation barriers increasing.

## **References:**

- 1/ Robert W. Cooper, Ph.D., Preservation of State-Based Insurance Regulation: An Ongoing Challenge in the US and the European Union, National Association of Insurance Commissioners, 2009.
- 2/ Title V of Frank Dodd Act, (Pub.L. 111-203, H.R. 4173).
- 3/ [www.rims.org](http://www.rims.org) website, June 2011.
- 4/ European Captives May Need Capital Boosts, Sarah Veysey, BusinessInsurance.com, June 2011.

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