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Underwriters of D & O and Professional Liability Insurance

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In this issue … In December 2013 the Federal Insurance Office (FIO) released its much-anticipated report on improving and modernizing the system of insurance regulation in the United States. This issue of CUG.COMments looks at the report.

BACKGROUND

The Federal Insurance Office, created under the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 ("Dodd-Frank"), was charged with producing various reports on the insurance / reinsurance industry. The most eagerly awaited report was that addressing the regulation of insurance (excluding health insurance) in the U.S. The report was released more than twenty months after its scheduled delivery, a delay remarked upon by many commentators, including this newsletter. To say the report was worth waiting for might be a slight exaggeration, but the FIO has produced a report that largely manages to maintain balance and perspective, objectively steering a course between those clamoring for federal intervention and those who feel that nothing substantive need change.

The "for or against federal control" argument is adroitly sidestepped in the report's conclusions: "Notwithstanding a decades-long debate about whether insurance should be regulated at the state or federal level… the debate is best reframed as one in which the question is where federal intervention is warranted, not whether federal regulation should completely displace state-based regulation."

Though the report tries carefully to maintain that neutral position, it does not hesitate to methodically list the deficiencies and shortcomings found in the current state regulatory system. If the report has not come to bury state-based regulation, it has certainly not come to praise it either.

THE REPORT: SELECTED EXTRACTS

Following an introduction, a brief history of insurance regulation, and mention of the recent financial crisis, the 65-page report covers a wide range of topics; here is a selection of some of them.

The efforts of the National Association of Insurance Commissioners (NAIC) to encourage consistent capital requirements for insurance companies across all the states are noted, however, using a phrase that will set a pattern for the entire report: "significant elements of non-uniformity remain." Regarding **risk-based capital** — generally speaking the measure of an insurer's capitalization relative to the risk inherent in its asset holdings and underwriting profile— the report comments that while standards may be largely uniform across the states, they are not always uniformly applied. Discretionary decisions made by states can "create competitive imbalances," so that insurers regulated by one state may suffer or benefit in comparison with insurers regulated by another state.

The report finds the treatment of **captive insurance companies** also varies considerably by state, as discretionary fees, taxes, and oversight are applied by each state according to its own unique approach. These approaches, the report notes, are often influenced by commercial reasons rather than regulatory. A report dated June 12, 2013 from the New York Department of Financial Services (NYDFS) into reinsurance captives used by life insurance companies is cited. The NYDFS found that: "existing state-based disclosure regulations are inadequate, inconsistent, and incomplete to properly identify and regulate these transactions; and that reserves were diverted and risk-based capital was artificially boosted, misleading regulators, investors, and the general public." It would be hard for the FIO to be more critical than that.

Credit for reinsurance generally refers to how insurers use reinsurance they purchase to reduce the liabilities on their financial statements. In general, reinsurance bought from a U.S.-based reinsurer will permit the buyer to receive credit for 100 percent of those transferred liabilities. However, if the reinsurer is not licensed, approved or accredited by the applicable state, that reinsurer must typically post qualifying collateral equal to 100 percent of the estimated assumed liabilities in order for the buyer to take the full credit on its statement. This may be an arcane issue, but it is not insignificant: according to the report, non-U.S. reinsurers account for at least 58 percent of reinsurance premium volume ceded by U.S.-based insurers.

The states' approaches on this issue are again characterized by a lack of unanimity: only eighteen states have so far adopted some form of authorization for the state regulator to accept less than 100 percent collateral from non-U.S. reinsurers —and even those authorizations are "not uniform in structure or implementation." The FIO report proposes that the U.S. Treasury and the United States Trade Representative combine to bring about "nationally uniform" treatment of reinsurers.

The report has a section on **Corporate Governance of Insurance Companies**, first noting that corporate governance is a "broad and expanding area of supervisory interest," and then commenting that: "there is an absence of state law or regulation applicable to corporate governance specific to insurers." On this subject the NAIC has yet to draft a Model Act; this omission was remarked upon by the International Monetary Fund (IMF) in its 2009-10 assessment of the U.S. financial system.

Insurer group supervision is addressed by the report, noting that state regulators are authorized to supervise insurers at the individual level, but are unable to exercise any control over an affiliate operating outside the state. In other words, state regulators are generally powerless to influence a larger insurer group that a single insurer may be part of. Why this matters is thus described by the report: "Experience with recent insurer insolvencies…illustrates that a comprehensive understanding of an insurer group could have resulted in a safer and more stable system." Although the NAIC was mindful of the issue, creating in 2010 the Holding Company Model Act, only fourteen states have currently adopted the act, while it is still pending in fifteen others.

On the question of **insolvent insurers** and **receivership**, the report reiterates its familiar plea for uniformity and consistency that is currently absent. The Insurer Receivership Model Act was published by the NAIC for this purpose in 2005, but universal adoption has proved elusive: only two states have enacted legislation based on the NAIC model.

The refrain continues for **state guaranty funds** —funds set aside to help compensate policyholders of admitted insurers that fail: "States should adopt and implement uniform policyholder recovery rules so that policyholders, wherever they reside, receive the same maximum benefits from Guaranty Funds." And if this is not achieved: "federal involvement may be necessary to ensure the fair treatment of all policyholders."

Turning to producers' interests, the report looks at the **National Association of Registered Agents and Brokers Reform Act** (NARAB II), previously discussed in this newsletter and supported by virtually every constituency in the insurance industry. Unsurprisingly, the report firmly supports the act, but not without a mild swipe at the current system of multi-state broker licensing: "The lack of uniformity creates duplicate administrative and regulatory burdens with no corresponding consumer benefit."

That sentiment might apply equally to the next topic: **product approval,** the process by which each state reserves the right to review, approve, or reject, an admitted insurer's products. "The absence of a uniform national standard and protocol for product approval," declares the report, "is a continuing complaint for insurers that argue the lack of uniformity creates inefficiencies and compromises the ability to offer the same products simultaneously…. on a nationwide basis." While acknowledging that qualifying large commercial risks are exempted from review by some states, the report suggests that: "commercial lines insurance regulation must continue to modernize."

The federal **Non-Admitted and Reinsurance Reform Act of 2010** comes under scrutiny from the report, describing the current inertia and the almost farcical inability or unwillingness of states to organize themselves into alliances to effect surplus lines tax reciprocity, as permitted under the act. The situation is little changed from when this newsletter looked at the issue in July 2012. “Further federal action on this issue may be warranted” is the diplomatic verdict of the report.

COMMENT

Not every element of the FIO report has been mentioned here, but the recurring themes evident in this short review pervade the entire document. It is not just that the state-based system must improve, it is that the system must also undergo significant structural changes —including federal involvement as appropriate— to better serve the needs of consumers and industry participants. In its concluding remarks the report comments: “Any system with 56 [including D.C., and non-state territories] independent jurisdictions is inherently limited in its ability to regulate uniformly and efficiently.” Explicit criticism of this unwieldy and outdated system has been largely withheld, but criticism implied by the repeated call for change is strong: “The *status quo*, or a state-only solution, will not resolve the problems of inefficiency, redundancy, or lack of uniformity, or adequately address issues of national interest.”

As mandated under Title V. of Dodd-Frank, the report was delivered to Congress —in practice the House Financial Services Committee— on December 12, 2013. Equipped with the FIO report, that committee, and ultimately Congress, will consider the future role of the federal government in regulating insurance. ❖

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