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Department of the Treasury
Federal Insurance Office
MT 1001
1500 Pennsylvania Avenue, NW
Washington, DC 20220

Ladies and Gentlemen:

The Committee on Insurance Law of the New York City Bar Association is grateful for the opportunity to respond[1] to the FIO's October 17, 2011 Notice and Request for Comment (the "Request").

The Committee is composed of lawyers representing a diverse cross-section of the insurance community, including lawyers in private practice, in-house counsel at insurance carriers and producers across multiple lines of insurance business, trade association officials, regulators, policyholder lawyers, insurance arbitrators and other types of insurance professionals. This letter represents the views of the Committee as a whole and not necessarily those of any particular member thereof.

With the adoption of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 ("Dodd-Frank")[2] and developments in state insurance law and at the National Association of Insurance Commissioners ("NAIC"), a potential expanded role for the Federal government in insurance regulation has come into sharper focus. We express no view herein on the proper allocation (if any) of insurance regulatory responsibilities between the states and the Federal government.

Below we consider six areas in which a Federal role is either evolving or contemplated by the passage of Dodd-Frank, and we offer in turn some comments on how such a role could be helpful or harmful to public policy.

[1] This letter was prepared by a subcommittee of the Committee on Insurance Law comprising Rachel Coan, James Corcoran, William Latza, Jill Levy, Richard Liskov, Daniel Rabinowitz, Francine Semaya, Jared Wilner and Thomas Workman. Nicholas Curmi, a guest participant on the Committee, and Joseph Sulzbach, a student member of the Committee, served as non-voting members of the subcommittee.

[2] Public Law 111-203 (hereinafter cited as "Dodd-Frank Act").

Enforcement of foreign judgments. Historically, a U.S. domestic insurer ceding business to a reinsurance company that is not licensed by the cedent's state regulator or any other U.S. state (a "non-admitted reinsurer") has been permitted to take full credit for reinsurance as an admitted asset on its financial statements only when the reinsurer posts collateral equal to at least one hundred percent of the risk being reinsured. Recently however, some states, including New York[3], New Jersey[4], Indiana[5] and Florida[6], have begun permitting their domestic insurers to take credit for cessions to non-admitted reinsurers without requiring full collateral. Under the new rules, the state insurance commissioners have discretion to award credit to ceding insurers depending on a series of factors. Additionally, in line with these developments, the NAIC has recently adopted changes to its Credit for Reinsurance Model Law and Regulation[7]. This general relaxation of the credit-for-reinsurance rules increases the likelihood that more reinsurance ceded by U.S. carriers to off-shore reinsurers will be unsecured than has been previously allowed under state insurance law. Accordingly, where a non-admitted reinsurer fails to meet its claims-paying obligation to the U.S. carrier, the absence of collateral will now tend to make it more likely that the ceding carrier will have to resort to a judicial remedy in order to collect reinsurance recoverables. Such claims, however, once reduced to judgment, may not always be capable of successful enforcement in a foreign jurisdiction.

Although the Committee expresses no view herein on the merits of the various changes taking place in credit-for-reinsurance laws, it believes that the new rules present an opportunity for the FIO to engage international regulators in an effort to facilitate the enforcement of foreign judgments. The FIO is empowered to represent U.S. interests abroad[8] and does not face the same constitutional constraints as state insurance departments. The FIO is uniquely situated to address this concern on behalf of U.S. domestic ceding insurers and would be well advised to do so.

Market conduct regulation and solvency regulation. At present, states, and not the Federal government, regulate both insurance company market conduct (*e.g.,* the use of policy rates and forms, sales practices, claims handling and other "retail" activities) and insurance company solvency. These two public policy objectives are often in tension with one another. For instance, an insurance department considering a rate application from an admitted carrier needs to balance the policyholder's immediate need for an affordable product with a concern for the carrier's financial health and the viability of the overall market for that product in that state.

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3 11 N.Y.C.R.R. 125.4(h).

4 N.J.S.A. 17:51B-2(f).

5 Ind. Code Ann. §27-6-10-16 as added by 2011 Ind. PL 11.

6 F.S.A. 624.610(3)(e).

7 NAIC Model Laws, Regulations and Guidelines 785 and 786. Amendments adopted by the NAIC to these models in November 2011 authorize the state insurance regulator to allow balance sheet credit where a domestic insurer cedes reinsurance to a non-admitted reinsurer that nevertheless meets certain financial strength criteria. The amendments do not become effective until or unless adopted by the legislature or insurance department of the applicable state.

8 Dodd-Frank Act §313(c)(1)(E).

This need for balance serves the public well insofar as it enhances regulatory accountability. The regulator's dual role as market-conduct and financial regulator, for example, tends to inhibit his or her ability to take politically expedient action in the name of consumer protection. Accordingly, in considering whether the Federal government should be charged with responsibility for various aspects of insurance regulation, it would be unwise to vest the authority to regulate market conduct and solvency in separate levels of government (for example, retaining market conduct at the state level but moving solvency regulation to a Federal body, or *vice versa*). For the market conduct function to be separated from the solvency regulation function would be to invite the market conduct regulator to make decisions about rates, forms and other consumer activity with no direct responsibility for, and no direct knowledge of, the impact of a given directive on the long-term fiscal health of the insurer. This will only increase the likelihood and frequency of insurance company failures. Conversely, the solvency regulator who cannot consider the reasonableness of rates from the consumer's standpoint would be ignoring a crucial factor in maintaining a competitive marketplace and ensuring consumer protection.

Harmonizing state laws to achieve market certainty. Without expressing a view herein on whether Federal regulation is desirable, some aspects of insurance law warrant, at a minimum, harmonization across state lines. This is particularly true in cases where geographical or demographic differences do not supply a logical justification for disparate legal results, multiple regulatory processes or inconsistent regulatory requirements. Indeed, the NAIC has articulated a policy of achieving uniformity of state laws in a variety of areas, such as producer and insurer licensing and life insurance policy form filing requirements.[9] Although certainly commendable, the NAIC's efforts to date towards promoting uniformity have produced uneven results.

Ironically, one area of insurance regulation where Congress has already legislated has made harmonization *more* difficult and presents a lesson on how not to achieve uniformity. The provisions of Dodd-Frank concerning non-admitted insurance (surplus lines)[10] are largely oriented toward the goal of ending extra-territorial application of state insurance laws (*i.e.*, the ability of two or more states to have jurisdiction over the same event). For instance, under Section 521(a) of Dodd-Frank, no state other than the home state of an insured may require payment of any premium tax for non-admitted insurance.[11] States "may" establish procedures to allocate among themselves the surplus-lines premium taxes paid to an insured's home state.[12] Dodd-Frank further provides that Congress "intends" that each state adopt "nationwide uniform requirements, forms, and procedures" that provide for the allocation of such premium taxes among the states.[13] The Federal legislation, however, does not *prescribe* such allocation or a method to achieve such allocation. As a result, two rival allocation "compacts" as well as a possible

[9] *See*, *e.g.*, "Proposed NAIC 2011 Budget", Nat'l Assoc. of Insurance Commissioners, Oct. 2010, at Executive Summary pp. 2, 40, 132 and 141 and Note 1 to Audited Financial Statements.

[10] Part I of the Nonadmitted and Reinsurance Reform Act of 2010 (Dodd-Frank Act, Tit. 5, Subtit. B.)

[11] Dodd-Frank Act §521(a).

[12] *Id.*, §521(b)(1).

[13] *Id.*, §521(b)(4).

compromise[14] are vying for support among the various states, and some large states (such as New York) have been hesitant to join any kind of compact because of the fear that they will lose tax revenues on a net basis. The long-term consequences of this stalemate could include uncertainty concerning the extent of tax liability associated with a surplus lines transaction. This problem does not affect only surplus lines producers and insurers. Policyholders with risks that are difficult to place in the admitted market also suffer when regulatory confusion and concerns over potential tax liabilities impede the placement of vitally needed coverage.

Insurance company receivership. Item 12 of the Request solicits comment generally on a prospective "Federal resolution authority" for insurers.

Insurance company insolvency has been held by the United States Supreme Court to be "the business of insurance"[15], the regulation of which is reserved to the states under the McCarran-Ferguson Act[16], and is accordingly governed by state rehabilitation and liquidation laws. These laws vary in their details from state to state, but in general state insurance receiverships differ from other insolvency resolutions in at least five critical ways:

- The state insurance laws all include the concept of "rehabilitation" of an insurer and many include the concept of conservation, rather than simply reorganizing debts and/or liquidation.
- The state insurance laws all provide that policyholders are senior to virtually all other unsecured creditors for purposes of the distribution of assets in an insurance liquidation.
- With very few exceptions, the pertinent state insurance supervisory official acts as the court-appointed receiver of an insolvent insurer.
- Subject to certain limitations, policy obligations of insolvent licensed insurers are funded by solvent insurers through a nationwide system of state insurance guaranty associations. The guaranty associations are created by statute and are involved in the day-to-day administration of covered claims of insolvent insurers in receivership. They routinely handle exigent circumstances that require prompt attention (such as adjudicating assertions of "hardship" claims).
- State insurance laws recognize separate account products (such as variable life and variable annuity products) that are not chargeable with general liabilities of the insurer.[17]

For insurance to perform its role in the economy, policyholders, claimants, beneficiaries and the public must have confidence that insurance obligations will be performed. The protections afforded by the state insurance regulatory system support that confidence, and

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[14] For an account of efforts to establish consensus around a single compact, *see* Arthur D. Postal, "Kentucky Surplus-Lines Compromise Gains Support", in *Propertycasualty360*, Aug. 23, 2011, available at http://www.propertycasualty360.com/2011/08/23/kentucky-surplus-lines-compromise-gains-support.

[15] *U.S. Dept. of Treas.* v. *Fabe*, 113 S. Ct. 2202 (1993).

[16] 15 U.S.C. §§1011-1015.

[17] Additional considerations relating to separate accounts and related products are discussed *infra*.

the Committee believes it is critical that any involvement by a Federal governmental entity in the resolution of an insolvent insurance company perpetuate that confidence by taking into account these specific features of state insurance insolvency law. To fail to do so would create the potential for considerable ambiguity and uncertainty. In the event of a Federally administered resolution of an insurer, this uncertainty could create needless instability in the financial system at a time when the system may be ill-equipped to handle it.

We note that the term "Federal resolution authority" as used in Item 12 can refer to one or both of two concepts. The first, which exists only hypothetically, would be a body of Federal law that governs insurer insolvency comprehensively, in substitution of existing state insurance receivership law. Dodd-Frank neither contains any such provisions nor expressly authorizes such a regime[18]. While we do not express any view herein on the merits of replacing the fifty state insurance-receivership statutes with a comprehensive Federal insurance insolvency statute, we do believe that incorporating insurers into the Federal bankruptcy law or into the specialized insolvency regimes of Federally-regulated entities (*e.g.,* banks) would, without significant tailoring of existing Federal law, be a mistake. It would have the effect of jettisoning key features of state insurance law that promote fairness and efficiency in administering insurer resolutions, and unnecessarily compromise the certainty and confidence that is essential to the risk mitigation function of insurance.

The second connotation of "Federal resolution authority" is the involvement of a Federal governmental body in the administration of a state-law governed insurance receivership. For instance, under Dodd-Frank, the FDIC can be placed in the unprecedented situation of administering an insurance company receivership. This can arise if (i) the insurer is determined to be one whose default would create serious adverse consequences for U.S. financial stability and (ii) the state insurance regulator fails to act within 60 days of the determination that an insurer is insolvent.[19] Although in theory there is no inherent reason that a Federal official should not be able to act as an insurance company receiver, insurance company insolvencies are liability-based phenomena. We believe that any Federal role would be deficient if the applicable Federal official did not avail himself or herself of the considerable expertise that resides within the state-based system regarding insurance claims and related liabilities.

Policyholder priority and separate accounts. Sub-items (ii) and (iii) of Item 12 specifically request comment on "loss of the priority status of policyholder claims over other unsecured general creditor claims" and "the loss of the special status of separate account assets and separate account liabilities" respectively. We address these in turn.

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[18] Section 203(e)(3) of Dodd-Frank expressly provides that where an insurance company has been designated as one whose failure would cause serious adverse financial consequences, its receivership must occur pursuant to applicable state law, even if the Federal Deposit Insurance Corporation (the "FDIC") is acting as receiver (discussed *infra*).

[19] Dodd-Frank Act §203(e).

First, policyholder claims are senior in right of payment to claims of general creditors of an insurer undergoing liquidation.[20] To subordinate policyholder claims to the same or lower level of priority enjoyed by general creditors (as suggested by the Request) would be a departure from decades of commonly accepted insurance law. No aspect of the 2008 financial crisis was created by the prospect of policyholders receiving distributions prior to other claimants in an insurance company receivership, and no aspect of the crisis would have been averted had policyholders' priority been lower than their current status. In addition, no aspect of Dodd-Frank either explicitly or implicitly contemplates an inversion or diminution of policyholder seniority in liquidation. The prospect of policyholders' no longer being "first in line" in an insurer insolvency would likely cause market disruption, uncertainty concerning existing insurance arrangements and insolvencies and a loss of public confidence in the insurance system, with consequent entrepreneurial decline.

Second, we address "the loss of the special status of separate account assets and separate account liabilities." Except in very rare circumstances, state insurance receivership laws do not expressly protect separate account products, but in many states a distinct statute elsewhere in the insurance code specifically provides that separate account assets are not to be used to satisfy any insurer general account liability.[21] These statutory protections have given rise to a number of investment-oriented life products, such as variable life insurance and variable annuities, which are also subject to U.S. securities laws and hence in many instances constitute registered, publicly offered securities.[22] Accordingly, these products are regulated even more rigorously than ordinary insurance products because they are subject to the dual regulatory regimes of Federal securities law and state insurance law. Dodd-Frank does not contemplate, either explicitly or implicitly, any change in the legal status of insurance separate accounts. It is likely that any diminution in the protected status of separate accounts would lead to market disruption, less consumer choice and flexibility and confusion concerning in-force separate account products and their legal status, without any corresponding increase in market efficiency, consumer protection or systemic risk management.

Any Federal body having jurisdiction over insurance should be a forum where regulated companies can express concerns and provide perspective. Above all else, the Committee would like to stress that insurance is a complex industry very different from other financial services and from other forms of commercial activity. The various types of specialist professionals that are employed or engaged by insurers include actuaries, underwriters, statutory accountants, lawyers, risk managers, technology experts and numerous others. Each of these fields has its own highly developed professional standards, technical literature and institutional knowledge. A healthy insurance market is dependent on all of these.

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20 *See, e.g.*, Insurance Receivership Model Act (NAIC Model Laws, Regulations and Guidelines 555-1), §801; New York Ins. Law §7434(a)(1) and §7435(a).

21 *See, e.g.*, Model Variable Annuity Regulation (NAIC Model Laws, Regulations and Guidelines 250-1), §4(C); New York Ins. Law §4240(a)(12).

22 Pension funds, in particular, commonly purchase group variable products in order to fund their payment obligations to pensioners; the fact that the invested assets are insulated from the insurer's general account provides a major inducement for such purchasers to acquire these products.

Insurance regulators function best when they do not merely impose or enforce requirements but rather when they work collaboratively with the entities they regulate in an effort to understand their businesses, limitations, strengths, weaknesses and concerns. While state insurance departments do not always see eye-to-eye with their regulated companies (nor should they be expected to), these departments have made efforts to develop the same kinds of internal expertise and technical resources to be able to regulate the industry intelligently. Any attempt by the Federal government to enter the insurance regulatory space should do the same, taking into account the unique characteristics of this industry, the technical complexity of the insurance business and the vast bodies of institutional knowledge within insurance firms that must be engaged in order to achieve the fairest and most efficient regulatory outcome.

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Our Committee would be pleased to respond to any questions on the foregoing. The Committee also welcomes the opportunity to assist the FIO both in connection with Director McRaith's forthcoming report to Congress on how to modernize and improve the Nation's system of insurance regulation and, more generally, in advancing the FIO's important work.

Respectfully submitted,

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