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The Steering Committee of the EU-U.S. Dialogue Project
Attn: Mr. A. Thomas Finnell Jr., Senior Insurance Regulatory Policy Analyst
Federal Insurance Office
U.S. Department of the Treasury
1500 Pennsylvania Avenue, NW
Washington, DC 20220

Re: Dialogue Project on U.S./EU Insurance Regulatory Issues

Ladies and Gentlemen:

The Committee on Insurance Law of the New York City Bar Association (the "Committee") welcomes the efforts of the EU-U.S. Dialogue Project (the "Project") to promote mutual understanding and enhanced cooperation with respect to EU and U.S. insurance regulation and to identify the commonalities and differences between the two regimes. The Committee is also grateful for the opportunity to make this written submission[1] to the *Request for the EU-U.S. Dialogue Project for Public Comment on the Technical Committee Reports Comparing Certain Aspects of the Insurance Supervisory and Regulatory Regimes in the European Union and the United States*, issued September 27, 2012 (the "Request"). We commend the work of the Steering Committee and believe that the continued work of this group will have a positive impact on the future of insurance regulation in the U.S. and EU.

The Committee comprises 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. Without limiting the

[1] This letter was prepared by a subcommittee of the Committee on Insurance Law consisting of Peter Bickford, Leah Campbell, James Corcoran, Nicholas Curmi, Matthew Gaul, Frederic Garsson, Drexel Harris, Tandis Hassid, Jill Levy, David Luce, Francine Semaya, Gail Wallach and Dan Rabinowitz and student member Joseph Sulzbach.

foregoing, the views expressed herein do not purport to reflect the views of members of the Committee who are public officials, and such members have expressly abstained from all Committee deliberations concerning this letter, including the determination on whether to make a submission at all.

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Introduction

The Committee believes that an effective, transparent system of insurance company regulation is desirable not only because it ultimately protects consumers but also because such a system promotes fair and vigorous competition in the insurance marketplace. Effective solvency regulation of financial groups can also moderate the kind of systemic risk or "contagion" that is believed by many to have triggered the 2008 financial crisis. The Committee supports the work of the Project and believes that regulation in the EU and the U.S. should not be so different as to either disrupt the availability of insurance protection and commerce across borders or create undue burdens or advantages for regulated entities. This letter addresses aspects of financial regulation of insurers and their affiliates as discussed in the Request, primarily Technical Committee Report 2, *Group Supervision*, and Report 3, *Solvency and Capital Requirements*.

In the U.S., the state-based and NAIC-facilitated risk-based capital ("RBC") rules have been in effect for almost two decades. The RBC regime provides a meaningful measure of insurer capital adequacy relied upon by not only regulators but rating agencies, investors and other constituencies. New tools being developed by the NAIC and the states, discussed in the Request, include revisions to the Insurance Holding Company System Regulatory Act (the "Holding Company Act") and own-risk solvency assessment ("ORSA") requirements. A number of these reforms have been developed by the NAIC's commendable Solvency Modernization Initiative, implemented shortly after the 2008 financial crisis. The utility of these new measures is uncertain at this juncture, particularly insofar as these techniques are still in their infancy and subject to implementation and interpretation in the various states.

Furthermore, the Solvency II implementation date has recently been delayed until January 1, 2014 and will likely be delayed further depending on when the proposed "Omnibus II" Directive is finalized and adopted by the EU. The Omnibus II Directive will, among other things, amend the legal form that the Solvency II Level 2 implementing measures will take (and which therefore cannot be agreed upon until Omnibus II is finalized) and introduce transitional measures in a number of key areas, not least of which is the equivalence of non-EEA country regulatory regimes. Significantly, it is still unclear whether the U.S. will be included in any transitional equivalence arrangements, a position that the Project's conclusions following its second phase will undoubtedly shed some light on.

Mindful that all of these processes involve significant efforts from multiple participants and stakeholders, all of these developments (and delays) are perpetuating uncertainty among global insurance groups concerning not only required capital levels but the internal systems required to measure them.

Comments

Below we offer four observations that we submit are responsive to points raised in the Request and, we hope, add some perspective to the Project's ongoing work.

1. Impact of U.S. Federalism on Insurance Regulation

In delineating the differences between insurance regulation in the U.S. and the EU, we believe that the Request omits a key point – the role played in U.S. insurance regulation by the U.S.'s distinctive allocation of governmental powers between National and state authorities, *i.e.*, Federalism.

Like many other activities not expressly covered in the U.S. Constitution, insurance was historically regulated at the state level. Indeed, for decades, the U.S. Supreme Court repeatedly held that insurance did not constitute "commerce" within the meaning of the interstate commerce clause of the Constitution[2]; therefore, the Federal government had no authority to regulate it. Following a 1944 Supreme Court case that held that the sale of insurance across state lines did in fact constitute interstate commerce[3], thus subjecting insurance to Federal regulation, the U.S. Congress in 1945 adopted legislation (the McCarran-Ferguson Act[4]) reserving regulation of the business of insurance to the states unless a Federal law specifically addresses the regulation of insurance.[5]

With the emergence in the 1970s of the Holding Company Act and similar statutes such as the predecessor to Article 15 of the New York Insurance Law, state insurance laws for the first time imposed regulation on transactions between insurance companies and their *affiliates* in addition to insurers themselves. While courts have upheld the ability of states to regulate holding companies within the framework of the McCarran-Ferguson Act[6], some cases have struck down application of these laws where such application has been motivated by protection of investors (as opposed to policyholders)[7] or has conflicted with enforcement of Federal securities laws designed to regulate corporate mergers and acquisitions.[8] The focus of the U.S. regulatory scheme on regulation through states and not the Federal government is evident by the fact that with few exceptions (*e.g.*, Federal crop and flood insurance programs) insurance companies are chartered and organized under state law and receive state, not Federal, licenses to conduct their business.

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[2] *Paul* v. *Virginia,* 8 Wall. 168, 75 U. S. 183 (1869); *Hooper* v. *California,* 155 U. S. 648 (1895), *New York Life Ins. Co.* v. *Deer Lodge County,* 231 U. S. 495 (1913).
[3] *United States v. South-Eastern Underwriters*, 322 U.S. 533 (1944).
[4] 15 U.S.C. §1011 *et seq.*
[5] McCarran-Ferguson reserves the Federal government's right to regulate insurance in the future but only to the extent an act of Congress "specifically" covers the business of insurance. The statute also does empower the Federal government to enforce antitrust laws in cases of "boycott, coercion and intimidation".
[6] See, *e.g., Holyake Investments Ltd.* v. *Washburn*, 723 F. Supp. 42 (N.D. Ill., 1989); *Professional Investors' Life Ins. Co.* v. *Rousall*, 528 F. Supp. 391 (D. Kan., 1981).
[7] *SEC* v. *Nat'l Securities Inc.*, 393 U.S. 453 (1969).
[8] *Gunter* v. *AGO Int'l B.V.*, 533 F. Supp. 86 (N.D. Fla., 1981).

Accordingly, in the matter of insurance holding company groups, which include both insurance and non-insurance entities, the boundary between what states may and may not regulate remains unsettled. New requirements inviting states to take a more active role in overseeing non-insurers may add to this uncertainty. This state of affairs does not *per se* create or concentrate risk; however, it does signify that states' ability to regulate group risks is not unlimited. Accordingly, efforts to enhance state regulatory authority without clear parameters may face inherent inefficiencies and structural limits.

2. The Limits of Group Supervision by States

The principal objective of the Holding Company Act is to protect insurers from abuses by their parent holding company and to prevent holding company structures from circumventing laws intended to regulate insurers' operations and management.[9] As the Request notes, the Holding Company Act amendments adopted in 2010 add an enterprise risk component.[10] The Request cites this as a platform for group supervision by states, and as a practical matter we do not disagree.

However, we note there is a range of views among industry, commentators and others on the efficacy of particular components of the enterprise risk reporting requirements[11], and the NAIC to its credit did not undertake to make fundamental changes to the regulatory system to accommodate group supervision. As a result, the enterprise risk concept, as effectuated by the NAIC, is necessarily limited in its application and potential analytical value and is not, and should not be regarded as, a proxy for comprehensive group solvency regulation.

The concept of "enterprise risk", as defined in the Holding Company Act, purports to cover risks to the insurance group as a whole, but the specific contingencies mentioned in the definition suggest that the definition is appropriately concerned mainly with risks *to the insurer itself.*[12] It is not primarily focused on group risks in the abstract. The current U.S. regulators' focus on the "enterprise risk" posed to insurers, rather than "group risks" *per se*, is appropriate for at least two reasons. First, policyholders (whose protection is a key objective of solvency regulation) are not obligees of groups or holding companies but rather insurers themselves. Accordingly, regulating groups or holding companies as a primary object (rather than as incidental to regulating insurers) is currently not contemplated under the Holding Company Act or state-specific enactments. Even putting

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[9] Legislative History of NAIC Insurance Holding Company System Regulatory Act (*NAIC Model Laws, Regs. And Guidelines 440-1, Leg. Hist.*).

[10] Request, Topic 2.1 and Topic 3.1.

[11] Shortly after the NAIC's adoption of the enterprise risk requirement, this Committee issued a report to the New York State Insurance Department (now the Department of Financial Services) setting forth, among other things, some of these concerns. The report is available at http://www2.nycbar.org/pdf/report/uploads /20072159-InsuranceHoldingCompanyRegulationinNewYorkinLightofthe2010AmendmentstotheNAICModelAct.pdf.

[12] NAIC Insurance Holding Company System Regulatory Act (*NAIC Model Laws, Regs. And Guidelines 440-1,* §1F. "'Enterprise risk' shall mean any activity [or] circumstance . . . involving one or more affiliates of an insurer that, if not remedied promptly, is likely to have a material adverse effect upon the financial condition . . . of the insurer or its insurance holding company system as a whole, *including, but not limited to,* anything that would cause the insurer's [RBC] to fall into company action level. . . or would cause the insurer to be in hazardous financial condition" (emphasis added).

aside the Constitutional concerns discussed in 1. above, comprehensive group supervision by the states would require formidable structural changes in state holding company regulation and in the regulatory habits and culture of diversified insurance businesses.

This is illustrated by the fact that, while the ORSA requirements being implemented by the NAIC do look more holistically at groups than prior holding company tools, the NAIC has sensibly chosen to characterize ORSA as a component of enterprise risk management rather than a new regulatory tool for overseeing affiliated groups of companies. For instance, earlier versions of the ORSA technical guidance considered by the NAIC had included quantitative components such as estimates of "notional" amounts of various amounts at risk due to various contingencies. This was rejected in favor of a solely narrative approach.

3. Capital Standards Imposed on Systemically Significant Insurers

The Request does not address one of the central concepts of the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank")[13], the ability to subject certain banks and non-banks, including insurers, to heightened, Federally-based solvency regulation. The Committee notes that, more than two years after the adoption of Dodd-Frank, there is no specific sense of what the solvency standards will consist of in relation to non-banks.

In January 2012, the Board of Governors of the Federal Reserve System proposed heightened prudential standards that would apply to systemically significant entities.[14] Despite their potential application to both banks and non-banks, the proposed rules are mainly a variant of existing *bank* regulatory standards and are not easily adaptable to insurers. For example, the proposed rules contemplate risk-based capital requirements similar to those in effect for banks and refer to tier one capital and similar metrics. The Board of Governors implicitly conceded this mismatch between these standards and insurance company targets in October 2012 when it explained that it "*may* tailor the application of the enhanced standards to non-bank covered companies on an individual basis or by category, as appropriate" (emphasis added) and recognized the distinction between "bank-centric" and "insurance-centric" rules.[15]

In October, the Board of Governors finalized a portion of the proposed January 2012 rules, specifically those governing "stress testing".[16] However, while stress-testing is an important exercise for any financial institution, its application for insurers may be quite different from the way it is implemented for banks. The external factors to be assumed in stress testing need to reflect the real-world risks faced by the institution in question. For instance, testing the likelihood of factors that lead to a potential bank collapse (a "run on

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[13] Public Law 111-203.
[14] *Enhanced Prudential Standards and Early Remediation Requirements for Covered Companies*, Proposed Rule, Board of Governors of Federal Reserve System 12 CFR Part 252, Regulation YY, Docket No. 1438, January 5, 2012 (77 FR 594).
[15] *Supervisory and Company-Run Stress Test Requirements for Covered Companies,* Final Rule, Board of Governors of Federal Reserve System, 12 CFR Part 252, Regulation YY, Docket No. 1438, October 12, 2012 (77 FR 62378).
[16] *Id.*

the bank", driven by a wholesale withdrawal of deposits or defaults by borrowers) requires quite different analytics as compared with the risks faced by a property-casualty insurer.

To be sure, Federal policymakers have begun to implement more granular risk-based capital standards for systemically important firms. However, as these are necessarily converted to insurance-company requirements (once some insurers, as expected, are designated as systemically significant), we believe that there would be at least two objectives served by having the NAIC or states actively participating in the process of developing these standards. First, Federal policymakers would have the benefit of collaborating with regulators well-versed in the distinct financial metrics and business vocabulary of insurance companies. This would tend to decrease the risk that the Federal requirements ultimately adopted will be difficult to "translate" into the insurance business. Second, and more germane to the Request, state regulators and the NAIC might be able to distill concepts from Federal proposals that inform the *state*-based effort to monitor group risks. In the meantime, attempting to advance the state process will not be fully effective as long as the Federal government's response to the prospect of "systemically significant" insurers remains incomplete. Most important, however, is that the Federal government, in preparing these rules, must understand that insurers have different solvency standards and financial risks from those of other financial institutions.

4. The Roles of FIO and NAIC

Although Dodd-Frank exempts the "business of insurance" and the "regulation of the business of insurance" from the overall reform of the financial services industry[17], it is important to understand the role the FIO was intended to play with regard to the insurance sector. Dodd-Frank vests the FIO with the authority to monitor all aspects of the insurance industry, including identifying issues or gaps in the regulation of insurers that could contribute to systemic risks in the insurance industry or the United States financial system.[18] Specifically, the FIO is required:

- to recommend to the Financial Stability Oversight Council that it designate an insurer, including the affiliates of such insurer, as an entity subject to regulation as a non-bank financial company supervised by the Board of Governors.[19]

Dodd-Frank also calls upon the FIO to study

- [t]he costs and benefits of potential Federal regulation of insurance across various lines of insurance (except health insurance)[20] and
- [t]he feasibility of regulating only certain lines of insurance at the Federal level, while leaving other lines of insurance to be regulated at the state level.[21]

[17] See, *e.g.*, 31 U.S.C. §313(j).
[18] 31 U.S.C. §313(c)(1)(A).
[19] 31 U.S.C. §313(c)(1)(C).
[20] 31 U.S.C. §313(p)(3)(A).
[21] 31 U.S.C. §313(c)(1)(B).

Most significant is that the FIO is intended to "coordinate Federal efforts and develop Federal policy on prudential aspects of international insurance matters"[22], which we understand to mean that the FIO should serve as the voice of the U.S. as a whole on insurance matters on the international stage.

We commend the involvement of the NAIC in the effort to harmonize the regulation of U.S. and EU insurance industries. At the same time (and mindful that the NAIC and the FIO are both participants in the Project), we advocate that the FIO, in order to ensure that the U.S. is indeed speaking with one voice internationally, work closely with the NAIC on regulatory policy. Such collaboration would lend greater credibility to regulation of insurance in the U.S. on the international level, while still preserving the U.S. state-based regulatory system.

- For example, we believe that the FIO would be the most natural body to engage with governments outside the U.S. to find common ground on insurance regulation, particularly with respect to Solvency II and the inclusion of the U.S. under any transitional equivalency arrangements.
- In addition, we draw the Project's attention to two aspects of the FIO's role in shaping insurance regulation as contemplated by Dodd-Frank –
    - the FIO's and the U.S. Treasury Secretary's role in entering into recognition agreements with other jurisdictions[23] and
    - the FIO's authority to preempt state law that is inconsistent with such international agreements.[24]

  These statutory measures are not self-explanatory and require refinement and thoughtful implementation.
- The goal of "convergence" of the U.S. and EU systems is not one expressly called for in Dodd-Frank or in any state law or NAIC pronouncement. We understand that the Project is assessing the concept of convergence and note that FIO Director McRaith referred to this prominently in the October 12 hearing in Washington. Given the number of open items to be resolved in navigating U.S. and EU insurance regulation, as discussed herein and otherwise (such as capital standards for non-banks under Dodd-Frank and EU equivalency analysis), we would urge caution in assessing the value and efficacy of convergence as a goal with respect to the various topics covered by the Project. If convergence is pursued as a policy, it is critical that it be implemented at a pace that allows the industry sufficient time to react and adjust.

By the same token, the role of the NAIC will remain important regardless of these developments because only the states have the power to implement meaningful regulation of U.S. insurers and their groups. To this end we encourage the NAIC and its members to continue to offer their expertise to the FIO and to focus their international efforts through FIO. Such an allocation of roles would best suit the respective missions, strengths and capabilities of these important bodies.

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[22] 31 U.S.C. §313(c)(1)(E).
[23] 31 U.S.C. §313(r)(2).
[24] 31 U.S.C. §313(f).

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The Committee would be delighted to answer any questions or respond to any concerns that the Steering Committee may have regarding the foregoing matters. Feel free to respond to us by contacting the undersigned.

Very truly yours,

Daniel A. Rabinowitz
Chair, Committee on Insurance Law

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