The 60-second Seminar:

Insurance industry barely touched by Dodd-Frank Act except for surplus lines

Guest columnist:
Robert H."Skip" Myers, Jr.

Congress squandered a rare opportunity to reform the financial markets that spun out of control and wreaked havoc on our economy and the lives of millions of Americans. In the process, it revealed its inability to overcome the influence of vested interests and to generate a solution that is more than a patch for the holes in the existing flawed model.

H.R. 4173 (now known as the Dodd-Frank Act) is certainly substantial – more than 2,000 pages of new legislation and amendments to existing law. It creates the Consumer Financial Protection Bureau and a Resolution Authority to determine "systemic risk" and break up troubled financial institutions. The bill also enhances bank capital standards and limits a bank's ability to trade for its own account, invest in hedge funds, and to trade derivatives unless on open exchanges; although these three limitations were significantly diminished in the rush to arrive at a compromise bill. What is more significant, however, is what Dodd-Frank does not address.

Insurance Regulation

Insurance as a "financial service" could easily have been drawn into the Dodd-Frank maelstrom, but it was not, except in two respects. First, the bill creates an Office of National Insurance (ONI), which has only minimal investigative and oversight authority. Second, the bill enacts the "Nonadmitted and Reinsurance Reform Act." This Act has nothing to do with the financial crisis and is indeed so non-controversial that it was easily added to H.R. 4173 as a vehicle of opportunity.

Why was the insurance industry barely affected? Even though the collapse of AIG was a precipitating force in the financial crisis, it became clear that AIG's insurance companies were not at risk of insolvency. In fact, the insurance industry as a whole has survived the financial crisis quite well. The insurance industry survived without any government bail out funds (with the exception of a few of the very largest insurers which had dabbled in derivatives) because almost all insurers are not "too big to fail." There are probably 5,000 insurers in the United States, each of which is regulated by its state of domicile and the other states in which it is licensed. The state-based regulatory system, with all its complexity and administrative cost, has the salutary effect of limiting the concentration of risk so the failure of any single insurer presents no risk to the entire system. No one in Congress or the White House seems to understand this obvious lesson that 5,000 competing financial institutions are safer to the public than the current banking model; i.e., numerous very small banks and a handful of banks that are "too big to fail."

Even the ONI is a diminished version of the originally introduced office. It is authorized to conduct a study of the insurance regulatory system. This should be helpful in future efforts at reform, but ONI's preemptive authority is very limited. It can preempt a state law only if such law "results in less favorable treatment of a non-United States insurer domiciled in a foreign jurisdiction that is subject to an international insurance agreement on prudential measures than a United States insurer domiciled, licensed, or otherwise admitted in that State." In order to do this, the ONI will have to consult with the "appropriate state regarding any potential inconsistency or preemption" and then adhere to the federal Administrative Procedure Act by providing notice in the Federal Register, opportunity for comment, and then a further notice that the preemption has become effective. Any such finding is subject to judicial review. The Director of the ONI further has the opportunity (in addition to the opportunities presented by the Administrative Procedure Act) to "consult with State insurance regulators, individually or collectively…."

Surplus Lines Reform

The imposition of surplus lines reform on the states is very significant. Dodd-Frank cut through the Gordian Knot of overlapping, conflicting and inconsistent surplus lines laws by placing regulatory responsibility on a single state, similar to the way in which the Liability Risk Retention Act places authority in the hands of the RRG's state of domicile. The effect of this change will be to simplify surplus lines compliance enormously to the benefit of the industry.

The "home state" of the insured will have not only the sole responsibility for collecting all premium taxes, but also the enforcement of other regulatory requirements, such as the eligibility of the insurer and the determination that comparable coverage is not available in the admitted market. Interestingly, the "home state" is the principal place of business of the insured, not the insurer.

The "home state" will have the responsibility to allocate premium taxes to other states where the insured's risk may be present. This takes the burden off the surplus lines broker and places it squarely upon the "home state."

The law requires that eligibility requirements for insurers be uniform among the states. This will be enforced by compliance with the NAIC Non-Admitted Insurance Model Act or an interstate compact. Alien insurers will have to be listed on the NAIC's Quarterly Listing of Alien Insurers.

In addition, the law contains an exemption from the "diligent search" requirements in the admitted market for an "exempt commercial purchaser," which is a concept similar to that of an

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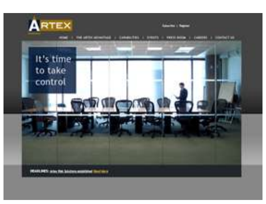

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"industrial insured." An "exempt commercial purchaser" must employ or obtain the services of a qualified risk manager, have aggregate commercial property and casualty insurance premiums in excess of $100,000, and have one of the following: 1) 500 full time employees; 2) net worth in excess of $20,000,000; or 3) annual revenues in excess of $50,000,000. Not-for-profit organizations and municipalities also can qualify under certain circumstances.
Not only will surplus lines brokers benefit as noted above, but they also will only be required to be licensed in the state of the insured. Moreover, states will be required to participate in the NAIC's National Insurance Producer Registry.

Freddie, Fannie and "Too Big to Fail"

H.R. 4173 does not even mention Fannie Mae and Freddie Mac, the Government Sponsored Entities ("GSEs") whose debts are growing daily without any relief in sight. Fannie and Freddie are at the heart of the financial crisis. The politically driven easy credit for unqualified borrowers spurred mortgage brokers, lenders and Wall Street investment bankers into a frenzy of risky behavior and short term profit taking.

Why has Congress avoided dealing with perhaps the biggest problem in Washington? Because the solution would be difficult, and no one inside the beltway will benefit from it. By mandating that banks provide easy credit and forcing GSEs to take the risk, the politicians received the two things they live on - votes from constituents who received easy credit and money from the financial industry that benefitted from it.

Now, the house of cards has collapsed. In order to reform the mortgage lending system, Congress would have to acknowledge fault and impose the duty to clean up the mess on the taxpayers. There is no "upside" for Congress to do this, and there is no measurable "good government" lobby in Washington to force Congress to act. Moreover, there has been no leadership from the White House (which is the normal counterweight to Congress) to address this issue. So, Fannie and Freddie roll on, untouched.

While Congress pretended in Dodd-Frank to address the "too big to fail" problem, it only made it worse. Working on the assumption that the crash of the financial markets was the result of regulatory failure, Congress enacted provisions that will facilitate the recognition of "systemic risk" and the winding down of those institutions that are "too big to fail" by the FDIC under the auspices of the Resolution Authority. This, ultimately, will encourage the moral hazard that creates the risk in the largest financial institutions.

What Congress has refused to do (and what the White House has refused to advocate) is to limit the size of financial institutions so that none of them are too big to fail. Again, this seemingly obvious solution was not considered seriously.

In sum, even though the United States suffered the worst financial collapse since the Great Depression, Congress failed to produce legislation to prevent the next big crash. At best, it will help to modulate the boom and bust cycle.

Insurance regulation, as cumbersome as it can be, should have been at least considered by Congress as a model to end the "too big to fail" problem. It wasn't.

Robert "Skip" Myers is the Managing Partner of the Washington, D.C. office of Morris, Manning & Martin. Specializing in insurance regulation with a particular emphasis on captives and alternative risk transfer, he may be contacted at myers@mmmlaw.com

Artex Commentary

By: Fay Okamoto

Additional commentary on the Non admitted and Reinsurance Reform Act and its implications for captive insurance companies:

Risk retention group captives were specifically excluded from the surplus lines reform provisions; however, no other types of captives were specifically excluded.

A captive fronted by an admitted carrier would not be directly affected by the surplus lines reform provisions. If the fronting carrier is a surplus lines carrier, the fronting carrier, insured, and surplus lines broker would be subject to the surplus lines taxes, eligibility, and reporting requirements specified by the Act.

The Act also clarifies which regulator has authority for ceding insurers' (i.e., fronting carriers') credit for reinsurance ceded. The Act firmly places this authority with the domicile of the ceding insurer, provided that domicile is accredited by the NAIC. This provision seeks to minimize challenges from non-domiciliary states that seek to impose their ceded reinsurance credit criteria. Under this provision of the Act, the domicile of the ceding insurer/fronting carrier, and that domicile's NAIC accreditation status, may be one facet to consider in selecting a fronting carrier.

Under this provision of the Act, the domicile of the ceding insurer / fronting carrier, and that domicile's status in terms of NAIC accreditation, may be one facet to consider in selecting a fronting carrier.

Captives who write policies direct to their insureds (for example, many single-parent captives writing deductible reimbursement policies) are admitted in their state of domicile, and non-admitted elsewhere. Such captives should exercise due care in transacting their direct business within their domiciliary jurisdiction, such as negotiation of the policy, delivery of the policy, and payment of the premium. Transacting business solely within the captive's domicile may avert claims for payment of non-admitted premium taxes from non-domiciliary states.

This continues to be a fluid situation requiring on-going monitoring from the alternative risk community. Artex welcomes any feedback or further interpretations of the applicability of the Act to captives and alternative risk transfer structures.

Fay Okamoto is Senior Vice President of Artex Risk Solutions, Inc. (Hawaii) and can be contacted at: fay_okamoto@artexrisk.com