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Fearless Predictions

Resolution issues and a covered agreement will take center stage in 2016

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In the February 2015 *NOLHGA Journal*, we wrote about the results of the 2014 mid-term elections and predicted what they meant for our industry and the guaranty system. Sara Powell and Scott Kosnoff (Faegre Baker Daniels) were interviewed by the *Journal* six months later about the state, federal, and international regulatory changes that matter the most to the system.

It's time now to bring both sets of prognostications forward to the present as we look at a Presidential/Congressional election year and beyond. What's hot and what's not? What matters and what doesn't? Who can change the safety net life as we know it, and who is chopped liver?

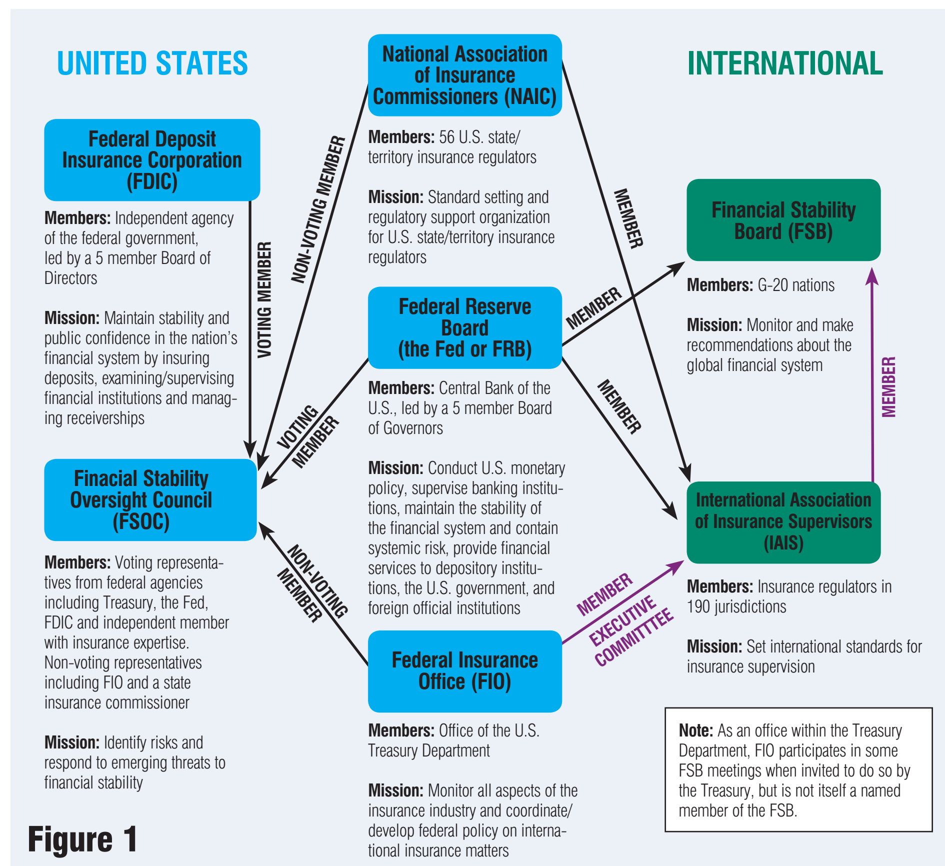

Figure 1

The Players

Take a look at this complex web of interactions (Figure 1).

These are the players we care about—and the actors whom NOLHGA President Peter Gallanis mentions in his financial services modernization reports at each MPC meeting.

Every single one of them will be potentially touching resolution/safety net issues in 2016.

For one thing, the predictions in our last two *Journal* articles mentioned above

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have come true—federal/international discussions and debates have not abated, and the NAIC and its state regulator members are devoting more and more time to the new reality. Plus, while capital standards and group supervision monopolized 2015, resolution is bubbling to the top and will inevitably get more air time moving forward.

Predictions

At the IAIR Forum during the last NAIC meeting in Washington in November 2015, we were asked to make some predictions about what to expect from a Democrat or Republican President in 2017.

On the Democrat side of predicting, we refer everyone to Hillary Clinton's 2016 economic plan: https://www.hillaryclinton.com/issues/plan-raise-american-incomes/. That plan embraces and strengthens the Dodd-Frank Act (DFA) structure.

Republican predictions are more difficult. Congress, now in the hands of Republicans, is watching every DFA move by the federal agencies with skepticism. They lie in wait for a Republican President in 2017 who could lead a charge to nip, tuck, or slash the DFA. Here's what we predict would happen if we had a Republican Congress *and* a Republican President.

SIFI Designations: Any expansion of the systemically important financial institution (SIFI) designation list—which now includes insurance companies AIG, Prudential, and MetLife—is likely to stop. That process is driven by political appointees, so it can be directly affected by a new administration skeptical that insurance companies can even be systemic.

FIO's Philosophy: The Federal Insurance Office (FIO) and its parent, the U.S. Treasury Department, would likely be a little more respectful of state regulation and skeptical of growing federal influence over insurance, at least in the short run.

CFPB Interest in Insurance: The Consumer Financial Protection Bureau (CFPB) has been wandering over into insurance consumer protection issues. That would almost certainly stop. The activities of the CFPB could be restricted, in general, and an aggressive march over to insurance would likely not happen.

The Dodd-Frank Reform Agenda: DFA "reform" means legislation, and the reformers can't get much reform through the Congress right now. A Republican President doesn't necessarily change that. That means FIO, FSOC, and all the rest are still around doing their Dodd-Frank jobs.

International Standard Setting: The international agenda probably isn't affected, at least at first. That is driven by the independent Federal Reserve and FDIC. In any event, that train may have left the station, and it's hard to reverse quickly—international standard setting is already affecting regulation, and that isn't going to stop.

Federal Reserve Authority: Between the statutory independence and the "train has left the station" effect, Federal Reserve influence over insurance regulation and capital should continue to grow.

In November 2015, the Republican majority on the House Financial Services Committee passed six insurance bills touching on some of the above issues. The NAIC's Policyholder Protection Act even became law through the year-end omnibus appropriation.

FIO remains active, where Director Michael McRaith has kicked off the process toward a reinsurance covered agreement that screams state regulation preemption and strikes terror in the heart of some in the NAIC. See the summary below, and please also read pages 63–65 of FIO's 2015 Annual Report, which addresses resolutions.

Affordable Care Act: Digging deep on the implications for the Patient Protection and Affordable Care Act (ACA) deserves its own treatment. But suffice it to say, Obamacare without Obama makes for a different landscape. Legislative action on Obamacare continued last year, including opponents finally passing a substantial repeal bill through the Senate. That action is symbolic with an Obama White House, but it would be a different story under Republican leadership. That story would center on whether Republicans would match their talking points and fully repeal the ACA.

Short of that, they would likely repeal large pieces of the law, including lessening the individual and business mandates; repealing, rather than delaying, the so-called Cadillac tax; and making permanent the budget neutrality of the risk corridors that support health insurers in the exchanges. And even absent full or partial repeal, regulatory implementation and enforcement (or lack thereof) under a Republican President would, yet again, change the healthcare landscape in fundamental ways.

Covered Agreement

In short, insurance conversations no longer stop at our shores, even when the subject is the U.S. insolvency safety net.

There is no better example of that than what is happening on the reinsurance collateral reform front—the "covered agreement" process that kicked off last November under the leadership of FIO.

Much has been written, said, and shouted about reinsurance collateral requirements through the years. In 2011, the NAIC passed amendments to its "Credit for Reinsurance Models" that, once implemented by a state, will allow certified reinsurers to post significantly less than 100% collateral for U.S. claims.

Thirty-two states have passed legislation to implement the revised NAIC Credit for Reinsurance Models, representing more than 66% of direct insurance premium written in the United States across all lines of business. An additional five states have indicated plans to take up the model law in the near future, which would raise the total market coverage to 93%.

Individual reinsurers are certified based on criteria that include, but are not limited to, financial strength, timely claims, payment history, and the requirement

that a reinsurer be domiciled and licensed in a "qualified jurisdiction."

But what U.S. regulators do on the subject is now not the end of the story. That's because on November 20, 2015, FIO Director Michael McRaith, through the U.S. Department of the Treasury and the Office of the U.S. Trade Representative (USTR), announced the group's intention to begin negotiating a covered agreement with the European Union. Under the FIO Act, the Secretary of the Treasury, FIO, and the USTR are authorized jointly to negotiate a covered agreement with one or more foreign governments, authorities, or regulatory entities.

A covered agreement is an agreement between the United States and one or more foreign governments, authorities, or regulatory entities regarding prudential measures with respect to insurance or reinsurance. Treasury publicly called for a covered agreement in FIO's 2013 Report, *How to Modernize and Improve the System of Insurance Regulation in the United States*.

In the covered agreement negotiations, Treasury and the USTR will seek recognition of certain prudential measures, including reinsurance collateral, to ensure a more level playing field for U.S. firms. The process will also negotiate potential standards on group supervision and confidentiality.

"Negotiating a covered agreement with the European Union is a critical step toward leveling the playing field for American insurers and reinsurers," said Director McRaith in his November 20 announcement. "As we begin negotiations with our European counterparts, I look forward to consultation and engagement with Congress, state regulators, and other stake holders so that we can pursue a covered agreement that provides tangible benefits for the U.S. insurance industry and consumers."

The start of the covered agreement process is a big deal. Key Congressional committees will be involved, and both Treasury and the USTR have said they intend to engage meaningfully with stakeholders, including state insurance regulators, throughout the covered agreement negotiations.

So here's what happens next. FIO and the USTR's steps in November were just that—initial steps. By the terms of the DFA's Title V, getting to a covered agreement will proceed in the following stages:

Step 1—Consultation: Before and during covered agreement negotiations, Treasury and the USTR must consult with four key Congressional committees. The consultation must include at least:

- The nature of the agreement
- How and to what extent such an agreement will achieve the purposes of Title V of the DFA
- The implementation of the agreement and its effect on state laws

Step 2—Agreement: Treasury and the USTR agree in principle with foreign authorities (here the European Union) to terms of the covered agreement.

Step 3—Submission: Treasury and the USTR jointly submit the proposed agreement to the Congressional committees on a session day.

Step 4—Layover: Ninety calendar days after submission, the covered agreement is effective. No Congressional approval is needed; just lack of adverse action.

Note that preemption of a state regulation by a covered agreement requires further consultation, procedures, and opportunity for judicial review.

One last observation on the covered agreement world: The effects of the covered agreement process are direct and immediate, but also potentially far reaching. A final covered agreement will directly affect reinsurance collateral and group supervision. The full weight of that direct impact will only be known when the actual negotiation process is complete. But the process has larger implications for insurance regulation as well. For the first time, FIO will have a hand in establishing national prudential standards for U.S. insurers—not aspirational international standards, not white papers, not moogy/foogy, but rather legally binding rules that U.S. insurance companies and state insurance commissioners will live by. Speculation about the direction of the federal role in insurance is still speculation, but it now gets sharper. Will the covered agreement process expand to more topics and/or more countries? Will the covered agreement process redefine the federal role so fundamentally that further involvement meets less resistance? Or will opponents of federal "encroachment" galvanize now that this shoe has dropped, leaving FIO its "one off" but drawing the line there?

The Resolution Debate

On top of this will be the insurance company resolution debates that will necessarily touch what the guaranty system does, what it's capable of doing under stress, and what it offers the consumers it protects and the industry it supports.

The reality is that state and federal regulators, along with the industry, have been focused the past 24 months on group supervision and capital standards. That focus will continue in 2016, but at some point, resolution/safety net issues will get on the discussion agenda, perhaps even near the top.

For example, 2016 begins with a consultation underway on a Financial Stability Board insurance resolution paper. The guaranty system has to be ready to describe, demonstrate, and document its capabilities under a variety of economic, operational, and legal scenarios and challenges. In short, we need to be ready to explain ourselves clearly to—and support the role of the guaranty system in this post/Dodd-Frank world in front of—all relevant constituencies.

There you have it. A Washington update to start the year off right. Next year's version will tell you what to expect from a new President and a new Congress—and the height of Donald Trump's Mexico-U.S. wall. ✯

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