» NCIGF Leadership
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A quarterly publication providing updates on guaranty fund estate and public policy matters

DODD-FRANK BASICS

The Dodd-Frank Wall Street Reform and Consumer Protection Act was signed into law on July 21, 2010.

All in all, insurance receivers and guaranty funds fare well under the new law, at least for now.

- But we should not assume that Dodd-Frank represents a Congressional endorsement of the state receivership or guaranty system.
- The insurance industry fared far better than banks during the recent economic crisis, however we have a continued need to confirm the state-based system's ability to handle the failure of a large, systemically important insurer (assuming, for the sake of argument, that such an insurer even exists).
- At most, Dodd-Frank represents a decision by Congress to defer the questions of who should regulate and liquidate insurance companies, and what role the guaranty funds should play. We anticipate that the upcoming FIO study will at least touch on these questions, with subsequent reports possible.
- In the face of this new interest in the state-based system, NCIGF and NOLHGA have worked closely with the NAIC to consider changes that can strengthen the system and confirm its ability to handle a Dodd-Frank receivership. NCIGF and NOLHGA have also continued to meet with members of Congress, Treasury, FIO, FDIC, FSOC and the Federal Reserve to make sure they understand how the guaranty system protects insurance consumers across the country.

What follows is a high-level summary of certain provisions of the law and its implementing regulations that may be of interest to the guaranty funds.

Regulation of Systemically Important Financial Companies

Large, interconnected financial companies that are systemically important will be identified by the Financial Stability Oversight Council and subject to stringent regulation by the Federal Reserve Board. Such companies could include insurers and insurance holding companies.

- FSOC is chaired by the Treasury Secretary, has three insurance members (only one of whom is a voting member) and 15 members overall. The insurance members are Roy Woodall (voting member), Missouri Insurance Director John Huff (appointed by the NAIC to a two-year term) and Federal Insurance Office Director Michael McRaith.

- In October 2011, FSOC published a proposed rule and interpretive guidance that describes how FSOC intends to determine which nonbank financial companies are systemically important. Under the proposed rule (which has not yet been adopted):

  - FSOC would employ a three stage process to determine whether a nonbank financial company could pose a threat to the financial stability of the United States.

  - In the first stage of the process, a set of uniform quantitative metrics will be applied to a broad group of nonbank financial companies in order to (i) identify nonbank financial companies for further evaluation and (ii) provide clarity for nonbank financial companies that likely will not be subject to further evaluation.

  - A nonbank financial company will be evaluated further in Stage 2 (and possibly in Stage 3) if it has total consolidated assets of at least $50 billion and meets any of FSOC's other thresholds concerning a company's outstanding credit default swaps, derivative liabilities, outstanding loans and bonds, leverage ratio and short-term debt ratio.

Resolution of Systemically Important Financial Companies

Dodd-Frank also creates a new mechanism for liquidating systemically important financial companies whose failure could destabilize the economy (as determined by the Treasury Secretary and President). The new mechanism is not limited to companies that are identified by FSOC and regulated by the Fed.

- While the FDIC will be appointed receiver of most of such companies, all insurers will remain subject to state receivership and guaranty fund processes.

- If the Treasury Secretary and President determine that action needs to be taken with respect to an insurance company in order to avoid destabilizing the economy, the domestic regulator has 60 days to file a receivership petition with the appropriate state court.

- In the unlikely event that the domestic state fails to act within 60 days, the FDIC is authorized to file a receivership petition in state court. But even under those circumstances, the domestic regulator arguably would still be appointed receiver.

- The NAIC's Dodd-Frank Receivership Implementation Working Group considered what procedural and statutory changes might be required for purposes of handling a systemically important insolvency, and the results are captured in a new chapter of the Receiver's Handbook. (NCIGF and NOLHGA were very supportive of that effort.) There is some effort at this point at the state level to implement some of the statutory changes suggested in the guideline appended to the Handbook.

- On January 25, 2012 the FDIC's Office of Complex Financial Institutions outlined its preferred strategy for resolving systemically important companies. It closely resembles Chapter 11 reorganization under the bankruptcy code.

    - Under most circumstances, the FDIC would be appointed receiver of the ultimate parent company. The FDIC, as receiver, would transfer most of the parent company's assets (including ownership of the operating subsidiaries) and some of the parent company's liabilities to a bridge holding company.

    - The parent company's subordinated debt (and possibly its senior unsecured debt) would remain with the receivership and would not be transferred to the bridge holding company. Creditors with valid claims would eventually receive an ownership interest in the bridge holding company.

    - "Equity solvent" subsidiaries (i.e., subsidiaries whose assets exceed their liabilities) would continue to operate under the bridge holding company.

- The FDIC could use the Orderly Liquidation Fund as needed to provide funds and guarantees to the bridge holding company, which in turn would downstream funds to recapitalize or provide liquidity to the operating subsidiaries.
  - Dodd-Frank created the Orderly Liquidation Fund to carry out Title II resolutions
  - All funding must be repaid by the receivership, clawback of preferential payments received by creditors or assessments
  - The OLF cannot be used to preserve insolvent financial companies or avoid closure and resolution
- The bridge holding company might also have funds from other sources, including cash and other assets transferred from the receivership and loans from third parties.[1]
- As stated in a proposed rule that was released on March 20, 2012, the FDIC believes its preferred resolution strategy "may be the best means of preserving value, minimizing the shock to the financial system, providing additional flexibility to mitigate cross-border resolution issues for global systemically-important financial companies, and allowing for a more expeditious resolution of a covered financial company."
- The NCIGF and NOLHGA are talking with the FDIC about how this model would work if the operating subsidiaries included one or more insurers. Because the FDIC's goal is to preserve value, we do not expect the FDIC to be focused on how an insurance company subsidiary would be liquidated (or, for that matter, on how the guaranty systems would protect consumers in the event of a liquidation). Instead, we anticipate talking to the FDIC about how it would decide which operating subsidiaries should remain open for business and under what circumstances.

Federal Insurance Office

Dodd-Frank also establishes a Federal Insurance Office in the Department of the Treasury with limited authority over all lines of insurance other than health. Former Illinois Insurance Director, Michael McRaith, is the Federal Insurance Office Director.

The FIO doesn't have any regulatory authority, but many see it as a federal regulator in waiting.

[1] Use of the Orderly Liquidation Fund would likely implicate the FDIC's lien authority. Using other sources of funds to recapitalize or provide liquidity to the operating subsidiaries would not implicate the FDIC's lien authority.

- For now, the FIO is charged with monitoring the insurance industry for regulatory gaps that could lead to systemic risk.

- Dodd-Frank also calls for FIO to complete and deliver to Congress a major study of U.S. insurance regulation that could provide impetus for future legislation.

- FIO is required to report on, among other things, the feasibility of regulating some lines of insurance at the federal level, the ability of the federal government to provide robust consumer protections, and *the consequences of subjecting insurance companies to federal resolution, including what that would mean for the guaranty fund systems*.

- FIO requested public comments in connection with the study, and NCIGF and NOLHGA submitted a joint comment. The study was due in January, but has not yet been released.