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Is a Federal Insurance Charter on the Horizon?

By Joel E. Rappoport

In January of 2003, the General Counsel of the Office of Thrift Supervision ("OTS"), the agency within the United States Treasury Department responsible for chartering and regulating federal savings associations, issued a total of two legal opinions. Both opinions dealt with the same subject – federal preemption of state consumer protection laws.

The legal opinions addressed Georgia and New York laws intended to protect consumers from various egregious mortgage lending practices often referred to as "predatory lending practices." Both state statutes are very controversial. Many lenders claimed that the statutes are overly broad and difficult to understand and interpret. In response to the Georgia Fair Lending Act, last year Fannie Mae and Freddie Mac, the two primary purchasers of mortgage loans in the secondary market, stopped buying loans governed by the Georgia statute.

In preempting these statutes, the OTS ruled that the federal savings associations it regulated would not be required to comply with most of the provisions contained in the New York and Georgia statutes. Last July, the National Credit Union Administration issued a similar ruling exempting federally chartered credit unions from compliance with the Georgia statute. Further, the Office of the Comptroller of the Currency (the "OCC"), the federal agency that charters and regulates national banks, is expected to take similar action when it rules on a recently received opinion request.

Why are we writing about two obscure legal opinions issued by a federal banking agency in a newsletter covering topics of interest to insurance companies? We describe these opinions because they illustrate in dramatic fashion the significant benefits that accrue to entities that are chartered and regulated by the federal government. Over the course of the past year or so, there has been a coordinated effort among various insurance industry trade groups to create a federal chartering and regulatory option for insurance companies. In this article, we will explain how such a federal chartering option might work, discuss the advantages of a federal charter option for insurance companies and review the proposals issued to date and the status of those proposals.

The Federal Charter Option

Currently, all insurance companies are chartered and regulated by a state government agency. These state

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agencies may authorize the formation of insurance companies, regulate their activities, examine them for compliance with regulations and enforce compliance through disciplinary proceedings and enforcement actions. The state legislatures and state regulatory agencies also adopt rules governing insurance activities and products in their states.

A coalition of industry trade groups is proposing to establish a chartering system for insurers that mirrors the existing dual regulatory system for banks. Under the bank regulatory system, banks may choose to be chartered and regulated by the applicable federal banking agency or by a state agency. Similarly for insurance companies, if the new regulatory system is enacted, any insurance company would be able to continue as a state-chartered insurance company, or it could elect to convert to a federal charter, in which case it would be regulated by a new federal insurance regulatory agency.

Advantages of a Federal Charter

In recent years, the increasing complexity of insurance products and the greater interest in transacting interstate insurance business have served to exacerbate dissatisfaction with the existing state-by-state regulatory system. Many insurance companies have expressed dissatisfaction with the burdens and costs of ensuring compliance with the different sets of regulations that apply in each state in which an insurance company operates. Moreover, insurance companies seeking to roll out new products on a national level now must gain the approval of separate state regulators. The option of a single federal regulator could provide a "one-stop regulatory shop" for insurance companies, resulting in a single source of regulation and a single approval process for new products. This could significantly reduce regulatory compliance costs and speed the time to market for new products.

The two recent OTS General Counsel opinions described above illustrate how insurance companies might benefit from a federal regulator. By preempting the New York and Georgia predatory lending laws, the OTS ensured that federally chartered savings associations would continue to be able to provide products on a national level under a uniform regulatory scheme. Similarly, a federal insurance regulator would be able to act to provide federally chartered insurance companies with a uniform, nationwide system of regulation.

Proponents of a federal charter option point to the benefits to consumers that would result if that option were available. Specifically, reduced barriers to new products would permit insurers to respond more quickly and efficiently to marketplace demands for new products. Moreover, a uniform, consistent and efficient regulatory system would result in lower costs for providing insurance, which would be passed on to

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Stradley Ronon Partner Authors Book on Mediation

Bennett G. Picker, partner at Stradley Ronon Stevens & Young, LLP, has authored a revised and expanded version of Mediation Practice Guide: A Handbook for Resolving Business Disputes (Second Edition), published by the American Bar Association Section of Dispute Resolution. Mr. Picker, a former Chancellor of the Philadelphia Bar Association, is a Fellow of both of the American College of Civil Trial Mediators and the International Academy of Mediators.

In a recent review by the Metropolitan Corporate Counsel, a nationally recognized leader in ADR called the Second Edition, "…the single best practical guide to business mediation I have seen." Further, a former Chairman of the American Corporate Counsel Association (ACCA) has stated, "…this book should be on the desk of every corporate counsel." ■

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consumers. Further, decreased barriers to entry within the states would result in enhanced competition to the benefit of consumers.

In addition, large insurance companies with multi-state operations have long argued that they are at a competitive disadvantage to national banks, which are active in the insurance products market. These entities have cited such things as prior product approval requirements and rate regulations, which are argued to be anachronisms that hinder insurers' ability to compete effectively with other financial services providers that are not subject to these regulatory restrictions.

The desire for an optional federal insurance charter is by no means unanimous. The idea of creating a federal regulatory system for insurance companies is strongly opposed by independent insurance brokers and smaller insurance companies that fear an influx of national competition in an arena that is currently almost entirely regulated on the State level.

Proposals for an Optional Federal Insurance Charter

The issue of an optional federal insurance charter has taken on greater prominence in the last two years as a result of several widely circulated and discussed initiatives. In late 2001, there were two legislative initiatives. First the American Council of Life Insurers ("ACLI") released a working draft of a comprehensive legislative proposal to establish optional federal chartering for life insurance companies. The proposal contained draft legislation for two bills to be called the National Insurer Act and the National Insurer Solvency Act (collectively, the "ACLI Proposal"). Shortly thereafter, Senator Charles Schumer (D-NY) sought to introduce a bill entitled the National Insurance Chartering and Supervision Act (the "Schumer Proposal").

The two proposals were substantially similar, with one of the principal differences being that the ACLI Proposal was intended to address optional federal chartering for life insurance companies only. The ACLI Proposal contemplated that health insurers and property and casualty insurers might also wish to avail themselves of a federal insurance charter, so the proposal was organized in such a way that general insurance law provisions, such as market conduct regulation, could be easily distinguished from those provisions that apply directly to life insurers, such as nonforfeiture benefits. In this way, other types of insurance companies could be added to the regulatory scheme later. The Schumer Proposal would provide for an optional federal charter for all forms of insurance companies. The following is a synopsis of the principal features of the two proposals.

National Insurance Agency and Commissioner. Both proposals would establish an agency within the U.S. Department of the Treasury for the purpose of chartering, regulating and examining insurance companies. The agency would be headed by a national insurance commissioner who is appointed by the President of the

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Stradley Ronon Partner Appointed Chair-Elect for ABA Fidelity and Surety Committee

Stradley Ronon Stevens & Young partner, Samuel J. Arena, Jr., was appointed chair-elect of the ABA Fidelity and Surety Committee. The Committee is comprised of thousands of fidelity and surety lawyers and company claim representatives from across the country. He will serve as chair-elect beginning in August 2003 and will take over as chair in August 2004.

Arena leads Stradley Ronon's Fidelity and Surety Practice Group and is an active member of the fidelity and surety community. He also serves as vice chair of the International Association of Defense Counsel, Fidelity and Surety Committee and recently co-authored The Manifest Intent Handbook, a comprehensive desk reference for fidelity practitioners, published by the ABA. ■

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United States for a five-year term. The agency would be self-financed by assessments on national insurance companies, and the agency would be empowered to provide for appropriate staffing.

Organization and Licensing. The proposals would permit national insurers to be organized as stock, mutual or fraternal insurers, and they could be owned by holding companies. National insurance companies would be required to obtain a license from the commissioner prior to engaging in underwriting activities. The proposals direct the commissioner to establish criteria for eligibility to obtain a federal charter. The criteria would address the character and competency of the party seeking a federal charter, as well as the financial resources of the proposed national insurer. While the ACLI Proposal contemplates only life insurance, in the case of the Schumer Proposal the license would specify the line or lines of insurance a company could underwrite. Under the Schumer Proposal, no company could obtain a license to underwrite both life and health insurance and property and casualty insurance, although a holding company could own more than one insurance company underwriting different types of business.

Powers. Both proposals contain provisions granting to national insurance companies all the powers and authority necessary for successful operation. These powers include the ability to enter into legal contracts and guarantees, acquire and own assets, engage in the underwriting and sale of insurance products, and establish and maintain separate accounts, and other incidental powers necessary to carry on insurance operations.

Financial Regulation. Both proposals contain provisions intended to ensure the financial security and stability of national insurers. In this regard, there are requirements regarding adherence to specified accounting principles and auditing standards, adherence to specified investment requirements and limitations and adherence to specific standards regarding asset valuation and risk-based capital requirements.

Consumer Protection. The ACLI Proposal requires the commissioner to establish standards to regulate the marketplace practices of national insurers to protect consumers. The commissioner is required to adopt regulations governing the advertising, sale, issuance, distribution and administration of insurance products issued and sold by national insurers and their distributors. The Schumer Proposal included specific consumer protection provisions patterned after NAIC model laws and New York law.

Corporate Transactions. Both proposals establish standards for mergers, consolidations and acquisitions involving national insurers and permit ownership of the insurer by a holding company. In addition, the proposals allow for conversion from mutual to stock form. The mutual-to-stock conversion provisions in the ACLI Proposal are based on existing California, New York and Wisconsin law, and, for demutualizations, includes a requirement that any plan of demutualization be subject to the approval by a majority of the members or policyholders of the mutual company who vote on the plan.

Receivership and Insolvencies. The proposals include receivership provisions taken from the model Interstate Compact Uniform Receivership Law. Those provisions provide for the commissioner to be appointed the receiver, liquidator, rehabilitator or conservator of national insurance companies. The proposals further require all national insurance companies to be members of the state guaranty funds in those states in which they do business. However, if a state guaranty fund does not meet minimum specified standards then a federal life and health guaranty corporation and a federal property and casualty guaranty corporation are created to protect benefits and claims for policyholders. The Schumer Proposal expressly states that the obligations of these corporations are not backed by the federal government, but are covered by

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assessments imposed on insurers. The ACLI Proposal states that it is based on two strongly held beliefs:

(i) that there should be a single insurance guaranty association mechanism handling the insolvency of both federally chartered and state-chartered insurers; and

(ii) that the existing guaranty association system should be the source of this unified coverage mechanism. In this way, consumers are adequately protected regardless of whether the insurer possesses a federal or state charter.

Status of the Proposals

Very little progress has been made on these proposals since their announcement in late 2001. The Schumer Proposal never progressed beyond the Senate Parliamentarian's desk due to jurisdictional issues. In June of 2002, an ad hoc alliance of various insurance and financial services industry trade groups announced that their members will unite behind a push for legislation to create a national charter for insurance providers. The group kicked off its campaign beginning with a series of three hearings in June 2002 on insurance regulation in the Subcommittee on Capital Markets of the House Financial Services Committee. However, no substantial progress has been made since then, and action during the current session of Congress appears unlikely given the other pending legislative priorities. Moreover, in our conversations with two members of the House Financial Services Committee, we have been advised that there has not been any significant push for action on a federal insurance charter from Congressional leadership. Instead, for the time being, insurers are seeking independent reform and modernization by the states.

The Future

Given the substantial advantages that would ensue to the benefit of large, influential insurance companies from the availability of an optional federal charter, we can anticipate renewed interest on this issue in the future. We will continue to monitor developments in this area and provide updates in future *Insurance Dispatches* as events warrant. ■

Joel Rappoport is a partner in the firm's Business Law Department. He resides in our Washington, D.C. office and focuses his practice on the representation of financial institutions and their holding companies and technology companies in corporate and securities transactional matters. He can be reached at jrappoport@stradley.com or 202-419-8406.