

A Closer Look

The Dodd-Frank Wall Street Reform and Consumer Protection Act



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The first in an ongoing series

Impact On Insurance Companies

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The Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank or the Act) may have a significant impact on insurance companies, from an overall regulatory structure standpoint as well as via new requirements that are applicable to portions of certain insurance companies' business. While the newly established Federal Insurance Office ("FIO") will not take the place of state regulation of insurance companies, the FIO is designed to play a prominent role in oversight and in coordination between the US insurance market and the international insurance market. Particularly for large global insurers and insurance companies that own thrift institutions, the potential designation as a systemically important nonbank financial institution will have a significant impact on how insurers navigate through their regulatory future.

Insurance companies are not immune to several other new standards for broker-dealers and investment advisors. In fact, the new rules promulgated by the Securities and Exchange Commission (SEC) may have a fundamental impact on the ability of life insurance companies that sell registered products to distribute such products. A significant possible impact is the potential shift from a suitability to a fiduciary duty standard when broker-dealers provide advice and recommendations to retail customers. In addition, the SEC will likely require that broker-dealers provide new disclosures to customers concerning conflicts of interest and the receipt of compensation. The Act also provides the SEC with broad new powers to prohibit or restrict sales practices, conflicts of interest, and compensation schemes that the commission deems contrary to the public interest. This *A Closer Look* provides an initial perspective on the impact some of these considerations may have on insurance companies.

The Federal Insurance Office will apply to all insurance companies except those that sell health insurance, crop insurance, and long-term care insurance (except to the extent that long-term care is a rider to a life insurance policy or an annuity contract). Other provisions of Dodd-Frank will apply to insurance companies that own broker-dealers, investment advisers, and thrift/banking institutions.

The Federal Insurance Office Act of 2010

The FIO Act is one provision of Dodd-Frank that specifically targets the insurance industry, and appears to be an attempt to pursue greater uniformity of the insurance regulatory environment in the United States. The office will, among other activities and particulars:

- Be headed by a director who will be appointed by the secretary of the treasury
- Monitor all aspects of the insurance industry, including gaps in the regulation of insurers that could contribute to a systemic crisis in the industry or the financial system
- Recommend to the Financial Stability Oversight Council that it designate an insurer as an entity subject to regulation as a nonbank financial holding company supervised by the Board of Governors of the Federal Reserve
- Coordinate federal efforts on prudential aspects of international insurance matters, including participation in the International Association of Insurance Supervisors
- Monitor whether underserved communities, individuals, and minorities have access to affordable insurance (except health insurance)
- Determine whether state insurance measures are pre-empted

The specific activities of the Federal Insurance Office, while not defined in the Act, will likely be focused on the collection and analysis of information related to the insurance industry, for the purposes of evaluating potential systemic risk of insurers on the US insurance market and at a global level. The FIO will also enter into information-sharing agreements with other regulatory bodies, so insurance companies may expect to see increased coordination of regulatory examinations.

The Act's provisions for pre-emption of state insurance measures appear to be focused solely on those measures that result in less favorable treatment of non-US insurers domiciled in a foreign jurisdiction than the treatment afforded US-domiciled insurers. The Act is clear that this pre-emption clause does not provide the FIO or Treasury with general supervisory or regulatory authority over the business of insurance.

Systemically important nonbank financial institutions

The director of the FIO will serve in an advisory capacity to the Financial Stability Oversight Council. A specific task of the director will be to recommend to the council that it designate an insurer as an entity subject to regulation as a nonbank financial holding company supervised by the Board of Governors of the Federal Reserve.

Insurance companies that are designated as systemically important will be required to register with the Federal Reserve Board ("FRB") and be subject to enhanced prudential standards established by the FRB. The standards include leverage and risk-based capital and liquidity requirements, concentration limits and stress tests, resolution plan and credit exposure requirements, and advance notice of significant nonbank acquisitions, among other considerations.

Specific considerations for designating insurance companies as systemically important have not been fully defined; however, large insurance companies that hold a dominant place in the domestic and global market may want to prepare for the possibility of designation. A first step in this kind of preparation would be to obtain a deep understanding of what it means to be supervised at a Federal Reserve oversight level. For those insurance companies that have become bank holding companies in recent years, significant change has been required for activities related to financial regulatory reporting, risk management structures, and holding company compliance programs, among other factors.

Modernization of insurance regulation

The Act requires the director of the FIO to complete a study of the insurance industry within 18 months after enactment of the Act. Specifically, the outcome of the study will be a report to Congress on how to modernize and improve the system of insurance regulation in the United States, including such areas as:

- Systemic risk
- Capital standards
- Consumer protection
- National uniformity of insurance regulation
- Regulation of companies and affiliates on a consolidated basis
- International coordination of insurance regulation
- Costs and benefits of federal regulation of insurance
- Feasibility of regulating only certain lines of business at the federal level
- Regulatory arbitrage
- Impact of regulatory changes in foreign jurisdictions on potential federal regulation
- Federal resolution authority

Additional studies that are called for in the Act will address additional topics:

- The global reinsurance market and the role it plays in supporting the US insurance market
- Impact of the Nonadmitted and Reinsurance Reform Act of 2009 on the ability of state insurance regulators to access reinsurance information for regulated companies in their jurisdictions

The study on modernizing regulation of insurance companies appears to have the goal of determining whether the industry would benefit from several of the same regulatory oversight provisions that apply to other sectors of financial services. This appears to be a considerable opportunity for insurance companies, if they are not already involved, to become involved in the debate over the regulatory framework that is desired for various aspects of the insurance industry. Additionally, with the increased activity of the National Association of Insurance Commissioners' Solvency Modernization Initiative, there appears to be a desire to consider solvency measures on a global scale, potentially equivalent to the European Solvency II directive.

Insurers with affiliated retail broker-dealers

A key provision in the Act that could have a significant impact on how insurance companies sell registered securities products (variable life, variable annuities) is the move toward a fiduciary standard for retail broker-dealers. The Act defines the fiduciary standard as acting "in the best interest of the customer without regard to the financial or other interest of the broker, dealer, or investment adviser providing the advice. . . [A]ny material conflicts of interest shall be disclosed and may be consented to by the customer." The fiduciary standard differs from the current "suitability" standard that requires that

broker-dealers recommend products that are suitable for the customer in light of the customer's investment objectives, risk tolerance, and other factors.

The Act directs the SEC to conduct a study and to report the findings, conclusions, and recommendations thereof within six months of enactment. The SEC is to evaluate existing legal and regulatory standards of care for brokers, dealers, and advisers (and their associated persons) when providing personalized investment advice and recommendations about securities to retail customers (defined as an individual person who uses such advice primarily for personal, family, or household purposes).

The Act sets an aggressive timeframe for the study, though the SEC will likely call upon its existing knowledge of the issue, its experience in regulating advisers under the fiduciary standard, and other relevant studies (e.g., the Rand study commissioned several years ago). A change to a fiduciary standard could have a significant impact on insurance-affiliated broker-dealers that typically offer only proprietary products to their customers. Areas of particular interest would be (i) how a fiduciary standard would impact the current insurance-affiliated broker-dealer model with respect to commission-based compensation and other sales incentives, as well as product selection and product features; (ii) how frequently a broker-dealer would need to review the customer's account; and (iii) how meaningful disclosure of conflicts of interest could be made.

For many insurance companies, their affiliated broker-dealers are already challenged by the existing suitability standards imposed for variable insurance and annuity products. In addition, the maintenance of adequate systems of supervision has been an area of significant focus during examinations by the SEC and the Financial Industry Regulatory Authority (FINRA). The compliance functions within the affiliated broker-dealers would likely be resource constrained in terms of oversight responsibilities and the need to find new opportunities to leverage greater technology resources for purposes of supervision, training, and new account onboarding.

Some questions about the application of a fiduciary duty

The Act contemplates the application of a fiduciary standard to broker-dealers, and addresses some potentially thorny issues in the application of the standard, namely:

Compensation. The receipt of commission-based compensation or other standard compensation for the sale of securities shall not, in and of itself, be considered a violation of the fiduciary standard.

Ongoing duty. A broker-dealer or registered representative is not required to have a continuing duty of care or loyalty after providing personalized investment advice.

Proprietary products. The sale of only proprietary products or a limited range of products shall not, in and of itself, be considered a violation of the fiduciary standard. (The SEC is authorized to require disclosure to and consent from customers of the limited range of products offered by the broker-dealer.)

Method of disclosure. The SEC is directed to facilitate the provision of "simple and clear" disclosures to investors regarding the terms of their relationship with brokers, dealers, and investment advisers and any material conflicts of interest.

If it adopts a fiduciary duty standard, the SEC will likely provide additional guidance with respect to these and other issues. A change in the legal standard for broker-dealers' interactions with retail customers would likely require that broker-dealers take steps to examine their current practices in light of the enhanced standard. For example:

- *To identify conflicts of interest and potential conflicts of interest for mitigation, elimination, and/or disclosure. This would include, for example, relationships with mutual fund and other asset management firms, including the payment and receipt of compensation, referral arrangements, and sales incentives, as well as trading and allocations, relationships with affiliates, and other possible areas of conflict.*
- *To review their broker compensation models and consider any conflicts of interest. While the receipt of commission-based compensation will not “in and of itself” be considered a violation of the fiduciary standard, what role will compensation play in incentivizing conduct consistent with a fiduciary role?*
- *To review the current product mix and determine whether particular products or product features should be dropped or altered. While the sale of only proprietary products or a limited range of products will not “in and of itself” be considered a violation of the fiduciary standard, what will a broker-dealer’s obligation be, if any, with respect to potentially superior products that the firm does not sell?*
- *To review current disclosures of conflicts of interest with a view toward enhancing disclosure of all conflicts and potential conflicts. Making new “simple and clear” disclosures about conflicts of interest and the terms of relationships would require significant care.*
- *To review the process around product creation and product selection and consider how it could be affected by a fiduciary model. This would likely require additional care in product creation and selection and careful consideration of product features.*
- *To create new training for supervisors and registered representatives concerning their new fiduciary obligations.*
- *To implement revised and new supervisory and compliance procedures, controls, and testing.*

The SEC is given new and unprecedented rule-making authority

Sales practices. The SEC is directed to examine and, where appropriate, issue rules “prohibiting or restricting certain sales practices, conflicts of interest, and compensation schemes for brokers, dealers and investment advisers that the SEC deems contrary to the public interest and the protection of investors.”

One question is how the SEC would use this new authority to prohibit certain sales practices, compensation schemes, and conflicts of interest. Typically, the SEC has relied on FINRA and the self-regulatory organizations (SROs) to craft sales practices rules for broker-dealers. Will the SEC seek to regulate sales practices more directly? For example, would it seek to prohibit sales seminars that target senior citizens? The use of boiler rooms for cold calling? Compensation for shelf space? Payments for referrals?

Pre-sale disclosure. The bill also clarifies the SEC’s authority to require “clear and concise” pre-sale disclosure to retail investors regarding investment objectives, strategies, risks, and costs, and any compensation or other financial incentive received by a broker-dealer or other intermediary in connection with the purchase of the product.

The SEC is likely to move forward with point-of-sale disclosure requirements. The Act does not limit such disclosure to particular products.

Financial planners

Government Accountability Office to study need for regulation. The Act requires that the Government Accountability Office (GAO) conduct a study within six months to evaluate current

oversight of financial planners and the effectiveness of regulations to protect investors and consumers from individuals who hold themselves out to be financial planners through the use of misleading titles, designations, or marketing materials. The study will consider:

- The role of financial planners in providing financial, tax, education, retirement, and estate planning
- Whether current regulations provide adequate ethical and professional standards
- Possible risks to investors and consumers by individuals who hold themselves out as financial planners in connection with the sale of financial products, including insurance and securities
- Possible risks to investors and consumers by the use of misleading titles, designations, and marketing materials
- The ability of investors and consumers to understand licensing requirements and standards of care of financial planners
- The benefits of regulation and professional oversight of financial planners

The recommendations are to include an appropriate structure for regulation and establishing standards for financial planners.

Insurance companies with significant broker-dealer operations and a significant suite of registered financial products are seeking to distinguish themselves from competitors by being able to provide an elevated level of financial planning services. This will likely impact how insurance companies pursue such distribution channels, and weigh considerations such as additional calls for regulation of the use of designations and qualifications.

Insurers with thrift subsidiaries

Insurers that own thrift Institutions (federal savings associations) face a number of regulatory and supervisory changes under Dodd-Frank:

- Within a year to 18 months after enactment, supervision and regulation of their these insurers' thrift subsidiaries will be assumed by the Office of the Comptroller of the Currency (OCC), since the Office of Thrift Supervision (OTS) will be eliminated. The OCC is regarded as a more demanding supervisor and examiner on both safety and soundness issues and compliance issues (with the exception of consumer protection, where OTS is perhaps somewhat more aggressive).
- Also within a year to 18 months after enactment, supervision and regulation of parent holding companies of thrifts, including insurers, will be transferred to the FRB from OTS. The FRB is expected to apply an approach similar to that for financial holding companies. In contrast, the OTS had developed a specific approach for supervising and regulating insurers that were savings and loan holding companies (SLHCs).
- Also, the Collins Amendment on capital will require all SLHCs to meet the same risk-based capital and leverage capital requirements currently imposed on insured banks. This imposition of capital requirements is required to come into effect five years after enactment. While the FRB is given a great deal of discretion in applying more stringent capital and other requirements to systemically important nonbank financial companies, including insurers, the Collins Amendment does not appear to include similar flexibility.

The impact of the Volcker Rule on insurers with bank or thrift subsidiaries

Insurers that own banks or thrifts are also subject to additional provisions aimed broadly at bank holding companies.

- The Volcker Rule provision of Dodd-Frank—created based on proposals by White House economic advisor and former FRB chairman Paul A. Volcker—prohibits “banking entities” from engaging in proprietary trading activities, with certain specific exceptions. The definition of banking

entities includes bank and thrift holding companies and their subsidiaries and affiliates. Insurers were able to obtain a special exemption from the prohibition for trading in financial instruments by a regulated insurance company or by affiliates thereof provided the activities are solely for the general account of the regulated insurance company and are subject to insurance regulation.

- However, the Volcker Rule also prohibits a “banking entity” from acquiring or retaining any equity, partnership, or other ownership interest in or sponsorship of a hedge fund or private equity fund, with certain exceptions. These exceptions include a limitation on the amount of any fund that may be acquired (not more than 3%) and a limitation on the amount in the aggregate that a banking entity can invest in such funds (3% of Tier 1 capital). There are no specific exemptions provided for insurers from the fund investment/sponsorship provisions. At least one major insurer has identified the application of the Volcker Rule as requiring it to scale back significantly its activities in this area.
- The Volcker Rule is not effective until two years after enactment, and thereafter there is a transition period of another two years that can be extended a further three to five years.

Other provisions that may impact insurers

- If an insurer owns a subsidiary that is engaged in non-insurance consumer financial services and that is not regulated by a state insurance authority, the SEC, or the Commodity Futures Trading Commission (CFTC), that subsidiary may also come under the jurisdiction of the new Bureau of Consumer Financial Protection.
- If an insurer maintains a substantial position in any swap categories that are determined by the CFTC (or the SEC for security-based swaps) to create substantial counterparty exposure that could have serious adverse effects on the US banking system or financial markets, it would be required to register with the CFTC (and/or SEC) as a major swap participant, subject to comprehensive regulation by the CFTC and/or SEC. While there are exemptions for commercial end-users, there are no exemptions for financial end-users. Insurers that are bank holding companies or SLHCs and that register with the CFTC or SEC will retain the FRB as their prudential regulator for swaps activities. For insurers not part of bank holding companies or SLHCs, it appears that the CFTC or the SEC will be their prudential regulator as well. The swaps registration provisions come into effect 360 days after enactment.
- If an insurer is a public company, it will be subject to certain corporate governance and disclosure provisions, including proxy access, say-on-pay, compensation committee independence, expanded clawback requirements, increased compensation disclosure, and chairman and CEO structures.
- The Financial Services Oversight Council can recommend to a state insurance commissioner or commissioners that an activity or practice conducted by insurers should be subject to new and heightened standards and safeguards. The insurance commissioner(s) would have to impose the recommended standards or safeguards (or explain why they have not done so) within 90 days. In any case where an insurance regulator refused, the council would notify Congress of the refusal and could recommend curative legislation.

While Dodd-Frank will have significant impact on insurance companies, many implementation issues are currently unclear and are subject to the SEC and other agencies' rulemaking processes and various statutorily directed studies. PwC will continue to monitor those developments and provide you with updates, which will all be available on www.pwc regulatory.com.

Additional information

If you would like additional information on Dodd-Frank or about PwC's Financial Services Regulatory practice, please contact:

Dan Ryan
FS Regulatory Practice
Chairman
646-471-8488
daniel.ryan@us.pwc.com

Gary Meltzer
FS Regulatory Practice
Managing Partner
646-471-8763
gary.c.meltzer@us.pwc.com

John Garvey
FS Advisory Leader
646-471-2422
john.garvey@us.pwc.com

PwC's Financial Services Regulatory Practice Leaders

Kenneth Albertazzi
617-530-6237
kenneth.albertazzi@us.pwc.com

Robert Nisi
646-471-4027
robert.nisi@us.pwc.com

Ellen Walsh
646-471-7274
ellen.walsh@us.pwc.com

David Albright
703-918-1364
david.albright@us.pwc.com

Ric Pace
703-918-1385
ric.pace@us.pwc.com

Dan Weiss
703-918-1431
dan.weiss@us.pwc.com

Thomas Biolsi
646-471-2056
thomas.biolsi@us.pwc.com

Richard Paulson
646-471-2519
richard.paulson@us.pwc.com

Gary Welsh
703-918-1432
gary.welsh@us.pwc.com

John Campbell
646-471-7120
john.w.campbell@us.pwc.com

Lori Richards
703-610-7513
lori.richards@us.pwc.com

Jeff Lavine
703-918-1379
jeff.lavine@us.pwc.com

David Sapin
646-471-8481
david.sapin@us.pwc.com

www.pwc regulatory.com

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