A CHALLENGE TO THE CUOMO ADMINISTRATION

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One of the hallmarks of the first several months of the administration of New York's Governor Cuomo was the presentation and adoption of his plan to consolidate the regulation of financial services, including the merger of the banking and insurance departments. The new law, The Financial Services Law, was enacted on March 31, 2011, and the merger of the two departments became effective on October 3, 2011. Over the coming months there will be considerable scrutiny by banking and insurance industry participants and observers to see whether or not the merger can or will meet the stated goal of the law "To establish a modern, dynamic, attentive, twenty-first century system of regulation, rule making and adjudication, that is responsive to the needs of the banking and insurance industries, as well as the state's consumers and citizens; . . ."[1]

Understandably, this initial scrutiny will be focused on the routine day-to-day interaction between the regulators, the regulated companies and the service providers to the regulated companies. Will there be the same access to the department as you were accustomed to in the past? Will you be dealing with the same department people? Will former banking regulators be handling insurance regulatory issues and vice versa? *Will things that used to take forever now take forever and a day?* People dislike having their routines changed, and how the merger will change routines both for the employees of the merged agencies as well as those dealing regularly with the agencies, is of the utmost immediate concern for many.

A Broader Issue

But there is another longer-term issue that needs to be addressed as well: What does the new Financial Services Law portend for the future of the business of insurance in New York?

Section 102 of the Financial Services Law sets forth twelve goals.[2] Not unexpectedly, a number of these goals are aimed at the regulatory role of the new financial services department, including the one cited above regarding establishing a modern regulatory system. More surprising, however, is that a number of these goals are economic goals directed toward the development and expansion of the insurance and banking industries in the state. Most notable among these goals are the following two, including the very first stated goal in the statute:

> "To encourage, promote and assist banking, insurance and other financial services institutions to effectively and productively locate, operate, employ, grow, remain, and expand in New York state; . . ."[3] and
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> "To promote, advance and spur economic development, job creation, private sector prosperity and wealth creation for all citizens and businesses in New York, with respect to their interaction and involvement with banks, insurance companies and financial services entities; . . ."[4]

These "business development" goals are interesting additions to the statute as passed. The stated purpose in the original draft submitted by the administration was starkly focused on regulation and enforcement.[5] The original title of the law was "the financial protection and regulation law" rather than the eventual "financial services law." The new merged agency was the "department of financial regulation" rather than the department of financial services", and the superintendent was the "superintendent of financial regulation" rather than the "superintendent of financial services."

The rather terse tone to the original draft bill, together with the emphasis on enforcement and consumerism, raised many eyebrows across the insurance industry. Did this proposed law portend a continuation of the Spitzer-era attacks on the industry? Was the regulation of insurance to become all about enforcement, attorney general style? Would this seemingly aggressive approach drive even more companies, investors and insurance consumers from the State? The insurance industry was understandably concerned with the focus of the merger bill on enforcement over reasoned oversight; with the attorney general/enforcement approach over industry and financial development; and with the potential conflicts that could be created by, among other things, including the department of consumer affairs as part of the merged insurance and banking departments.

To its credit the administration apparently listened to the concerns of the industry, legislators and others, and significantly modified the text of the statute to be more balanced between oversight, promotion and enforcement. In addition to the business development goals recited above, the revised statute removed the consumer affairs department from the merged department (leaving it under the auspices of the attorney general) and significantly modified the fines and enforcement provisions to a more reasonable and realistic level.

The question remains, however: do these changes reflect the actual attitude of the administration or are they simply a salve to calm industry objections? Does the administration truly intend to help develop the banking and insurance industries through actions as well as words, or will it emphasize enforcement over reasoned regulation? *Is it even possible for this administration to consider the needs of the industry on the same level as the needs of the insurance consumer?*

A Changed and Changing Industry

The insurance industry has changed dramatically in the past three decades, particularly in the area of alternative and specialized markets, and continues to explore new and better risk management tools. Insurance regulation in New York, however, has not kept pace with this changing landscape. Although a reputed leader in the area of insurance regulation, this leadership has been focused primarily on traditional personal lines such as auto, homeowners, life and health insurance. New York's regulators have historically been slow in adapting to the fast evolving and changing business environment, particularly in recognizing and accepting the needs of commercial insureds to access central market facilities and alternative risk spreading vehicles.

It is not that New York is unaware of this evolution. It is more of a matter of attempting to apply the same rigid regulatory scheme used in personal lines over these new markets and methods. *This regulatory rigidity essentially prevents these new markets from being used effectively in the State and forces our own domestic commercial insureds to go elsewhere – to other states or off shore – to fill their legitimate business needs.*

Back in the day when banks were actually in the business of lending money, I asked a senior officer of a client bank why he was approving a business loan in an amount greater than the amount requested. He stated that once you decide to make the loan to a business, make sure you lend them the full amount of what they need to succeed or you both lose. The same concept should apply to the regulation of insurance (or any business, for that matter). *Once a regulator agrees to allow an activity, it should make sure that it provides the regulatory environment for that activity to succeed.* This has not always been the case in New York, and this shortcoming is no more apparent than from the perspective of commercial insureds seeking in-state market alternatives.

New York's regulatory hesitancy in the commercial marketplace can be illustrated by three examples: the "free zone" for large commercial or hard to place risks, captive insurance companies and the stalled revival of the insurance exchange.

Example #1: The "Free Zone

The "free zone" legislation[6] was adopted in 1978 in the midst of an historic hard market (yes, hard markets once existed!) to allow domestic New York insurers to be able to address the immediate needs of their customers to insure hard to place or large commercial risks free of rate and form filing requirements without the customers having to go to the surplus lines or overseas markets. While modestly successful over the years, critics often point to the cumbersome process of getting new hard to place lines "white listed" for writing in the Free Zone, and for the limitation that, although free from rate and form filing requirements, the policy forms must comply with all and often irrelevant content requirements of the insurance law.

Earlier this year, the New York Legislature revised the Free Zone statute to coordinate its provisions with the Non Admitted and Reinsurance Reform Act, a part of the Federal Dodd-Frank legislation,[7] particularly to make the Free Zone exemption from rate and form requirements applicable to the newly defined "large commercial insureds." However, the thought of fully embracing the concept of allowing free negotiation between large commercial insureds and their carriers apparently was too much for the

Administration and the New York Legislature to accept. Included in the revisions to the Free Zone statute are the following provisions:

> Section 6303 (a) (3) . . . (B) the insurer shall file with the superintendent a certificate of insurance evidencing the existence and terms of the policy within one business day of binding the insurance coverage; and
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> (C) a policy form that has not been previously filed with the superintendent shall be filed with the superintendent for informational purposes within three business days after first delivery of a policy using such form, but no later than sixty calendar days after the inception date of such policy.

Filing for the sake of filing is, of course, an unnecessary burden on both the regulated and the regulator. Filing for "informational purposes" only begs the question: What purpose? Will the regulators be able to force changes in freely negotiated terms and conditions after the fact? Or upon renewal? Will these "information" filings add rather than remove uncertainty in the marketplace? In essence, by including these unnecessary, costly and burdensome provisions, *the Administration and the Legislature demonstrate a continuing unwillingness to cut the regulatory umbilical cord, even in the face of overwhelming consensus supporting the changes by the affected insureds and insurers.*

Example #2: Captive Insurance Companies

Captive insurance companies have become a widespread, effective risk management consideration for large commercial insureds. Captive insurers first appeared in general use in offshore jurisdictions that had greater tax benefits and easier capitalization requirements. As the concept matured, however, many states began adopting captive laws to meet the needs of domestic corporations with sound financial and regulatory oversight on shore. The first and most successful of the many states that adopted captive laws was Vermont, which has over 900 currently authorized captives.

New York also has a captive statute, but like so many other areas where it comes to supporting the commercial insurance market, it is severely limited in scope, and poorly supported. As former Superintendent of Insurance Gregory Serio stated in a recent article on New Jersey's foray into an expanding captive market:

> "[New York] state's indifference to the captive law is inexplicable. Whereas once the state had an open mind and open door to captive creation, it has mired those captives still here in bureaucracy and has neglected any opportunity to invite others to set up shop in New York."[8]

A recent development on the insolvency front underscores the shortcomings of the New York captive law. In his petition for the liquidation of Executive Life Insurance Company of New York filed in September, the superintendent as liquidator presented an elaborate plan to run-off Executive Life's remaining book of annuities through a special purpose vehicle supported by the assets of the estate and contributions from the various state guaranty funds and other sources. The special purpose vehicle proposed for this plan is a District of Columbia – not a New York -- captive entity![9] While there may have been other reasons, the obvious reason for not using a New York captive is that that the New York captive law does not allow captives to write life or health risks.[10] However, the Executive Life Plan has been under consideration for over two years, and in that time there was plenty of opportunity to seek expansion of the law to allow for this type of usage. Failure to do so only begs the question: *if using a captive to cover health and life risks is acceptable for use in a regulator-sponsored effort why is it an unacceptable usage by the industry?*

Example #3: Insurance Risk Exchange

Several years ago, Superintendent Dinallo raised the prospect of revitalizing the old insurance exchange facility authorized under existing Article 62 of the Insurance Law. His successor, James Wrynn, took up the project by creating an insurance industry working group to consider the feasibility of a revitalized exchange marketplace and its value to the development of a centralized insurance market in New York. In June 2010 the working group presented its preliminary recommendations for re-establishing an operating insurance risk exchange. Based on these recommendations, and numerous discussions with regulators, legislators, rating agencies, potential investors, underwriters, managers, brokers, intermediaries, financial institutions, and service providers, it was determined that there was sufficient support to move forward with the development of an action plan for the implementation of the recommendations and the re-establishment of an insurance risk exchange facility.

Such an action plan was drafted, including a step-by-step timetable and financial projections,[11] but no action has been taken by the current administration to allow release of the implementation plan – not even to the full Industry Working Group – or to allow supporters of the insurance risk exchange to actively pursue its establishment.

This inaction by the administration is puzzling. The insurance risk exchange project is primarily an industry project with no downside to the Administration. It is up to the exchange industry supporters to obtain support by the insurance and investment communities, including the commercial insurance consumers. A successful industry effort could return a focus on New York as an important insurance venue, create a significant number of jobs and generate much needed tax and other revenue. All that is needed from the Administration is a continuation of appropriate regulatory support consistent with the existing statute and the support provided in the effort to date by the Dinallo and Wrynn administrations.

What could be more squarely in line with the Merger Bill's stated purpose to "encourage, promote and assist banking, insurance and other financial services institutions to effectively and productively locate, operate, employ, grow, remain, and expand in New York state"?

While the administration has not expressly opposed the insurance risk exchange implementation plan, the continuing delay in allowing the industry the opportunity to consider and pursue the plan lessens the opportunity for success and is equivalent to yet another rejection of support for the industry.

The Challenge

So the challenge to the new administration is this: show the industry that you mean what you say in the Merger Bill; that you are willing to work with the industry to develop New York into a more expansive, central market for insurance companies and the insurance purchasers; and that you will provide the insurance industry and consumers with the legislative and regulatory tools they need to compete and thrive in an ever evolving business world.

Despite the negative signs in the three illustrations above, it is still not too late for the administration to demonstrate to the industry that it means what it says and will adapt to and support a "modern, dynamic, attentive, twenty-first century system of regulation, rule making and adjudication, that is responsive to the needs of the banking and insurance industries, as well as the state's consumers and citizens."

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Endnotes

[1] Chapter 18-A of the Consolidated Laws of New York, Financial Services Law §102(b).

[2] Section 102 reads in its entirety as follows:

§ 102. Department of financial services. The legislature hereby declares that the purpose of this chapter is to consolidate the departments of insurance and banking, and provide for the enforcement of the insurance, banking and financial services laws, under the auspices of a single state agency to be known as the "department of financial services" and to accomplish goals including the following:

(a) To encourage, promote and assist banking, insurance and other financial services institutions to effectively and productively locate, operate, employ, grow, remain, and expand in New York state;

(b) To establish a modern, dynamic, attentive, twenty-first century system of regulation, rule making and adjudication, that is responsive to the needs of the banking and insurance industries, as well as the state's consumers and citizens;

(c) To provide for the effective and efficient enforcement of the banking and insurance laws;

(d) To significantly and continually expand the attractiveness and competitiveness of the state charter for banking institutions and to promote the conversion of banks to such status;

(e) To promote and provide for the continued, effective state regulation of the insurance industry;

(f) To provide for the regulation, governance and success of developing creative and new financial services products;

(g) To promote the prudent and continued availability of credit, insurance and financial products and services at affordable costs to New York citizens, businesses and consumers;

(h) To promote, advance and spur economic development, job creation, private sector prosperity and wealth creation for all citizens and businesses in New York, with respect to their interaction and involvement with banks, insurance companies and financial services entities;

(i) To ensure the continued safety and soundness of New York's banking, insurance and financial services industries, as well as the prudent conduct of the providers of financial products and services, through judicious, cooperative, collaborative regulation and vigilant supervision;

(j) To protect the public interest and the interests of depositors, creditors, policyholders, underwriters, shareholders and stockholders;

(k) To promote the reduction and elimination of fraud, criminal abuse and unethical conduct by, and with respect to, banking, insurance and other financial services institutions and their customers; and

(l) To educate and protect users of banking, insurance, and financial services products and services through the provision of timely and understandable information.

[3] §102(a)

[4] §102(h)

[5] "A BUDGET BILL as submitted by the Governor in accordance with Article VII of the Constitution," Draft of 2-18-11 (the "Original Draft Bill"). Contrast the goals in the law as passed with the "Declaration of Policy" provision of the Original Draft Bill §201(b):

"The superintendent shall take such actions as the superintendent believes necessary to:

(1) foster the growth of the financial industry in New York through judicious regulation and Vigilant supervision;

(2) ensure the continued safety, soundness and prudent conduct of the providers of financial products and services;

(3) ensure fair, timely and equitable fulfillment of the financial obligations of such providers;

(4) protect users of financial products and services from financially impaired or insolvent providers of such services;

(5) encourage high standards of honesty, transparency, fair business practices and public responsibility;

(6) eliminate financial fraud, other criminal abuse and unethical conduct in the industry; and

(7) educate and protect users of financial products and services and ensure that users are provided with timely and understandable information to make responsible decisions about financial products and services."

[6] Article 63 of the New York Insurance Law

[7] Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010.

[8] "Christie Liberates Captives," by Gregory V. Serio, Insurance Advocate, March 31, 2011.

[9] Petition for Liquidation of Executive Life Insurance Company of New York, filed September 1, 2011 in New York Supreme Court, Nassau County (Justice Galasso), Index No. 8023/91.

[10] New York Insurance Law §7003(a)(3).

[11] In February 2010 the author was appointed by then Superintendent of Insurance James Wrynn as special advisor to the Exchange Working Group. In that role, the author was the principal drafter of the "Plan to Implement the Recommendations of the Industry Working Group," July 2011, which, as indicated, has not been approved for release by the Administration.