SENATE BILL REPORT
SB 5065

As of February 7, 2013

Title: An act relating to the settling of certain insurer transactions.

Brief Description: Regulating the settling of certain insurer transactions.

Sponsors: Senators Mullet and Benton.

Brief History:
Committee Activity: Financial Institutions & Insurance: 1/31/13.

SENATE COMMITTEE ON FINANCIAL INSTITUTIONS, HOUSING & INSURANCE

Staff: Edward Redmond (786-7471)

Background: Office of Insurance Commissioner. The Office of Insurance Commissioner (OIC) is authorized to regulate insurance in Washington. This includes licensing of agents and brokers, approval of insurance rate and form filings, collection of premium taxes, responding to consumer complaints, and oversight of investments and financial solvency.

The Washington Insurance Investments Act, first adopted in 1947, establishes the framework for investments by domestic insurers. To protect against insolvency through overtly risky investment practices, the OIC is authorized to set general limits and restrictions on the type of securities an insurer can invest in and the type of loans it can make. Such investments include public and corporate obligations, derivatives, and mortgage bonds. An insurer must also maintain signed, written records of its investments authorized by an officer of the insurer or by the chair of such committee.

Receivership. When an insurer becomes financially impaired or insolvent, the OIC is appointed by the superior court as receiver or liquidator of the insurer. The order of appointment as receiver or liquidator provides protections under statute to the insurer, policyholders, creditors, and stockholders.

The receiver or liquidator is charged with the management of the insurer's assets in order to preserve and maximize the interests of all claimants according to the class priorities under RCW 48.31.280. The assets of the insurer are the only source of funding to provide that management.

This analysis was prepared by non-partisan legislative staff for the use of legislative members in their deliberations. This analysis is not a part of the legislation nor does it constitute a statement of legislative intent.

The receiver's management of the insurer's assets allows for the generation of income and reorganization that often allows for complete rehabilitation of the insurer. If assets are removed from the estate, the receiver has fewer options for reorganization and less investment income from which to fund receivership management. If the receiver is denied the ability to maximize investment income, there are fewer insurer funds with which to pay policyholder claims. This shifts responsibility to the guaranty association to pay a greater portion of claims. Because guaranty association claims payments are funded through insurance industry assessments, this results in reduced premium tax collections to the state's general fund.

Guarantee Association. Insurance guaranty associations are organizations created by statute for the purpose of reimbursing policyholders and beneficiaries for losses resulting from the financial impairment or insolvency of insurance companies. Members of these associations are the individual companies authorized to write particular types of insurance within a state.

In Washington, insurance premiums are exempt from the state's business and occupation tax and are instead subject to a 2 percent insurance premiums tax. The premium taxes collected are disbursed to the state general fund.

There are two guaranty associations in Washington, one to protect property and casualty policyholders, and one for life and disability policies. When an insolvency or liquidation occurs, the member insurance companies of the affected guaranty association are assessed based on their percentage of Washington premiums; the assessment is limited to 2 percent of a member company's premiums. A member is exempt from a payment otherwise due if the payment would render them insolvent.

Members of both associations may offset any payments made to the guaranty fund against premium taxes due over a five-year period. An offset against premium taxes results in reduced premium tax collections to the state's general fund.

National Association of Insurance Commissioners (NAIC). The NAIC is the organization of insurance regulators from the 50 states, the District of Columbia, and the five U.S. territories. Formed in 1871, the NAIC provides a forum for the development of uniform policy when uniformity is appropriate.

In 2005 the NAIC adopted the Insurer Receivership Model Act (IRMA). An optional section of the IRMA, section 711, prioritizes the settlement of certain qualified financial contracts when an insurer is in receivership or liquidation. Modeled after Chapter 11 of the federal bankruptcy provisions applicable to financial institutions, section 711 allows counterparties of derivative transactions to assume a position of priority ahead of the receiver, policyholders, and other creditors, and immediately remove assets from the receivership. This priority arrangement supplants the requirement for an insurance company to hold a certain level of collateral when engaging in derivative transactions with their financial counterpart. Section 711 creates a safe harbor for the derivative counterparty by ensuring that they receive first priority for the settlement of claims in the event of an insurance company's financial impairment or insolvency.

The Wall Street Transparency and Accountability Act of 20l0 (Dodd-Frank Act). Title VII of the Dodd-Frank Act established new federal oversight of derivate markets. Under Dodd-Frank, insurers are characterized as financial entity end-users and are subject to mandatory clearing for certain derivative transactions, as well as initial and variation margin requirements for uncleared derivative transactions.

There are also proposed rules for enhanced documentation requirements and margin calculation requirements. Proposed margin rules provide that the initial and variation margin for uncleared derivative transactions must be calculated on a gross, rather than net, basis unless the parties are subject to a qualifying master netting agreement and obtain a legal opinion that key provisions of this agreement are enforceable, even in the case of bankruptcy or insolvency. IRMA section 711 satisfies this requirement.

Summary of Bill: Section 711 of the IRMA is adopted in substantial part. In the event of an insurance company's financial impairment or insolvency, counterparties of derivative transactions are authorized to assume a position of priority ahead of the receiver, policyholders, and other creditors.

A receiver may not prevent a transfer of money or other property arising under, or in connection with, a netting agreement or qualified financial contract that is made before the commencement of a formal delinquency proceeding. A transfer may be avoided, however, if the transfer was made with actual intent to hinder, delay, or defraud the insurer, a receiver, or existing or future creditors.

New definitions such as netting agreement, qualified financial contract, receivership, and transfer, are added to the Insurance Code chapter which provide standards for mergers, financial oversight, rehabilitation, and liquidation.

A netting agreement is defined as:
- a contract or agreement that documents one or more transactions between the parties to the agreement for one or more qualified financial contracts and that provides for the netting, liquidation, setoff, termination, acceleration, or close-out under or in connection with one or more qualified financial contracts, or present or future payment or delivery obligations, or payment or delivery entitlements amongst the parties to the netting agreement;
- any master agreement or bridge agreement for one or more master agreements; or
- any security agreement or arrangement, or other credit enhancement or guarantee or reimbursement obligation related to any contract or agreement.

A qualified financial contract is defined as any commodity contract, forward contract, repurchase agreement, securities contract, swap agreement, or any similar agreement that the commission determines to be a qualified financial contract.

Receivership is defined as any liquidation, rehabilitation, conservation, or ancillary receivership.

Transfer is defined to include the sale and every other and different mode, direct or indirect, of disposing of, or of parting with, property or with interest in property, including a setoff, or

with the possession of the property or fixing a lien upon property or an interest in property, absolute or conditional, voluntarily or involuntarily, by or without judicial proceedings.

Appropriation: None.

Fiscal Note: Available.

Committee/Commission/Task Force Created: No.

Effective Date: Ninety days after adjournment of session in which bill is passed.

Staff Summary of Public Testimony: PRO: If Wells Fargo buys $10 million of insurance on a finance product from U.S. Bank and U.S. Bank sells $5 million of insurance to Wells Fargo, then the net exposure is $5 million, not $15 million. Under the Dodd-Frank Act, you must put up collateral on your investment now; if a state does not have a netting agreement, you must put up extra collateral because the state views this as a $15 million transaction not a $5 million transaction. The challenge we find in this new environment is that every state that does not have a netting agreement in place ends up with insurance companies having to put up extra collateral for their financial transactions to hedge their portfolio. As part of that simplification, all the states that now have a netting agreement, when everything goes bankrupt, all these financial transactions get settled. The end result could be that the guarantee fund may have to kick in to repay the policyholders. The American Council of Life Insurers (ACLI) are in full support of this bill. Senator Mullet stated interest in working on matters that deal with financial services cluster ideas. I cannot think of a bill that better fits that target than this bill. The language in the bill was drawn from the NAIC model regulation, section 711. I believe the adoption was unanimous, it was not controversial. The OIC met with members from ACLI and Symetra Financial specifically to discuss this language and has no objection whatsoever. This is a well-vetted measure; it has been adopted in 20 states. Those states, like Washington, have significant domiciled life insurers that need to have a benchmark for these types of transactions and the netting effect that is modeled after the federal bankruptcy code.

CON: This is a too big to fail scheme that shifts the risk onto the taxpayers. This bill is not difficult to understand. Think in terms of shifting the responsibility of the loss, in spite of the netting agreement, onto the taxpayers. Taxpayers are having a hard time and they do not need to assume the risk of a bad investment made by an insurance company. A Harvard law professor by the name of Mark Roe wrote a law review article entitled "The Derivatives Market's Payment Priorities As Financial Crisis Accelerator" that is on point with the concerns raised about the impacts of this bill. This bill has much bigger implications than first thought. It will increase risk taking by insurers, it will deny the Insurance Commissioner full powers when there is a financial insolvency problem, and it will cost policyholders and taxpayers if enacted.

Persons Testifying: PRO: Senator Mullet, prime sponsor; Mel Sorenson, John Mangan, ACLI; Jacquie Veneziani, Symetra Financial.

CON: Senator Chase; Brian McCulloch, citizen.