



# JONES DAY COMMENTARY

## THE NEW YORK STATE DEPARTMENT OF FINANCIAL SERVICES AT THE ONE-YEAR MARK: A NEW AGGRESSIVE REGULATOR WORTH FOLLOWING

Since the New York State Department of Financial Services (“DFS”) began operations in late 2011, the agency appears to have lived up to its billing as an activist regulator of insurers and financial institutions. DFS has taken on several novel issues and will likely continue to do so. Insurers and financial institutions doing business in New York should keep DFS on their radar given the scope of its regulatory mandate and its initial enforcement activities since inception. Institutions outside New York may also want to monitor DFS’s initiatives, which may pique the interest of federal or state law enforcement and regulatory agencies in other jurisdictions and lead to similar or parallel initiatives.

### DFS’S ACTIONS SINCE INCEPTION

On October 3, 2011, the former New York State Banking and Insurance Departments were combined to create DFS.<sup>1</sup> The 4,400 entities DFS supervises

have about \$6.2 trillion in assets and include all insurance companies in New York, all depository institutions chartered in New York, the majority of United States-based branches and agencies of foreign banking institutions, mortgage brokers in New York, and other financial service providers.<sup>2</sup>

Since October 2011, DFS has announced several notable enforcement actions. Most recently, DFS entered into a settlement concerning the so-called force-placed insurance industry, which DFS began to investigate in October 2011. Force-placed insurance, also known as lender-placed insurance, is insurance that a bank, lender, or mortgage servicer places on a property that does not have the coverage required by the mortgage.<sup>3</sup> Lenders typically obtain force-placed insurance to replace coverage that the borrower has allowed to lapse or to supplement coverage the bank or mortgage servicer determines is insufficient. After its investigation, DFS claimed that the premiums borrowers pay

for force-placed insurance can be two to 10 times higher than premiums for voluntary insurance and typically provides less protection. The borrowers pay the costs of the higher premiums, and investors in residential mortgage-backed securities may in turn bear the costs if a foreclosure occurs. In March 2013, DFS settled with the country's largest force-placed insurer over DFS's claims that homeowners had been overcharged for force-placed insurance.<sup>4</sup>

Shortly after the settlement was announced, the Federal Housing Finance Agency ("FHFA"), which oversees Fannie Mae and Freddie Mac, filed a notice prohibiting the payment of fees or commissions by insurers for force-placed insurance.<sup>5</sup> The notice states that the FHFA considers force-placed insurance to be "contrary to prudent business practice, to appropriate administration of Fannie Mae and Freddie Mac [] guaranteed loans" and exposes Fannie Mae and Freddie Mac to "potential losses as well as litigation and reputation risks." A large portion of the costs for unpaid insurance are passed onto Fannie Mae and Freddie Mac.<sup>6</sup>

After the announcement of the settlement with the force-placed insurer, DFS's Superintendent, Benjamin W. Lawskey, sent a letter to other state insurance commissioners pressing them to pursue the same investigative and enforcement steps DFS had taken in the force-placed insurance industry. Recent public remarks by Superintendent Lawskey indicate that he believes any successful DFS initiatives can be a model for the investigation and prosecution of similar issues by other federal and state prosecutors and regulators. In the Superintendent's words, "[a] dose of healthy competition among regulators is helpful, and necessary, to preserve the safety and stability of our financial sector."<sup>7</sup> In Lawskey's view, DFS's work should be understood in the context of three types of federalism: (i) "cooperative federalism," (ii) "persuasive federalism," and (iii) "coercive federalism."<sup>8</sup> As Lawskey frames it, cooperative federalism occurs when a state regulator works closely and in collaboration with other federal and state regulators.<sup>9</sup> Persuasive federalism arises when state regulators lead by example, as with the force-placed insurance settlements that DFS achieved.<sup>10</sup> In Lawskey's view, DFS should resort to coercive federalism when it believes it must take more significant action before other regulatory agencies.<sup>11</sup>

## DFS'S FOCUS IN 2013

DFS Superintendent Lawskey has outlined in recent public statements three new issues that DFS will focus on this year: (i) ownership of insurance companies by private equity firms, (ii) captive insurance companies, and (iii) monitors.<sup>12</sup>

**Ownership of Insurance Companies by Private Equity Firms.** In the coming months, DFS will investigate investments made by private equity firms in insurance companies, particularly those that write annuity policies. DFS has found that ownership of insurers by private equity firms has grown dramatically over the past year. According to DFS, private equity's rapid growth in the insurance field may in part be due to the fact that certain regulations for insurance companies are not as strict as those for banks. Superintendent Lawskey has expressed the opinion that private equity firms can be unreasonably aggressive with risk and use significant leverage to maximize profits in a relatively short time frame. He believes this approach is at odds with the long-term outlook of annuity policy holders and could put them unnecessarily at risk. Moody's Investors Service also identified this as a potential issue in a recent research report.<sup>13</sup>

**Captive Insurance Companies.** In the typical captive insurance arrangement, a non-insurance parent company creates and owns a "captive" to insure the parent's risk.<sup>14</sup> Recently, some insurance companies have created special purpose vehicles that act as captives for the purposes of reinsurance, securitization, or reserve financing purposes.<sup>15</sup>

DFS began investigating the captive insurance industry in July 2012 when it sent letters to about 80 life insurers requesting information on their financial arrangements with captive insurance companies.<sup>16</sup> Superintendent Lawskey has said he is concerned with how insurers are using captive insurance companies to move billions of dollars in liabilities to offshore entities—most commonly to Bermuda or the Cayman Islands—or to states where the insurer is not based—most commonly Vermont.<sup>17</sup> He argues that what he describes as a "shadow insurance" industry is putting the greater financial industry at risk. He further asserts that insurers use the reserves they have moved offshore for other purposes, even though the parent company may be

a guarantor and therefore liable for any claims on reserves that have been diverted to other jurisdictions.

DFS is not the only agency investigating how reserves are being stored in captives. The National Association of Insurance Commissioners and the Federal Insurance Office are also examining the issue.<sup>18</sup>

**Monitors.** Monitors or consultants are periodically placed in a bank or insurer to ensure that the entity is complying with a regulatory or prosecutorial order or agreement. Because such monitors are hired and paid by the entities they are charged with monitoring, Superintendent Lawsby sees potential conflicts of interest. He believes that regulators should more actively manage monitors and that communications between monitors and regulators should improve.

## CONCLUSION

Given DFS's aggressive posture, its willingness to examine new issues, and its desire to establish precedents for other regulators and prosecutors to follow, banks, insurers, and other financial institutions—both in and outside New York—should keep DFS and its activities in view. In particular, given the particular subjects Superintendent Lawsby has stated will be a focus for DFS this year, private equity firms with certain insurance investments should be prepared to respond to DFS regulatory inquiries concerning whether their investment objectives are consistent with the interests of policy holders. In addition, banks and other financial institutions should be prepared to answer inquiries about the independence of any monitors or similar consultants affiliated with their organizations.

## LAWYER CONTACTS

For further information, please contact your principal Firm representative or one of the lawyers listed below. General email messages may be sent using our “Contact Us” form, which can be found at [www.jonesday.com](http://www.jonesday.com).

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## ENDNOTES

- 1 For a fuller discussion of the creation of DFS and its powers, please see our December 2011 *Jones Day Commentary*, "The Department of Financial Services: New York's Newest Financial Regulator" (available at [http://www.jonesday.com/departments\\_of\\_financial\\_services/](http://www.jonesday.com/departments_of_financial_services/)).
- 2 DFS web site, [http://www.dfs.ny.gov/about/staff\\_bios/blawsky.htm](http://www.dfs.ny.gov/about/staff_bios/blawsky.htm) (last visited May 8, 2013).
- 3 Press Release, DFS, Mar. 21, 2013.
- 4 *Id.*
- 5 Lender Placed Insurance, Terms and Conditions, 78 Fed. Reg. 19263-64 (Mar. 29, 2013).
- 6 Alan Zibel and Leslie Scism, "U.S. Cracks Down on 'Forced' Insurance," *Wall St. J.* (Mar. 26, 2013).
- 7 Evan Weinberger, "New York Bank Regulator To Examine Compliance Consultants," *Law360* (Apr. 18, 2013).
- 8 Elizabeth D. Festa, "NY doubles down on captives, private equity firm scrutiny," *LifeHealthPro* (Apr. 18, 2013) (available at <http://m.lifehealthpro.com/2013/04/18/ny-doubles-down-on-captives-private-equity-firm-sc>).
- 9 *Id.*; Benjamin M. Lawskey, "Regulating in an Evolving Financial Landscape," The A.A. Sommer, Jr. Lecture at Fordham Law School, Apr. 18, 2103.
- 10 *Id.*
- 11 *Id.*
- 12 Lawskey, *supra* note 9.
- 13 Darla Mercado, "Private-equity jumping into annuities could be bad news for insurers," *InvestmentNews*, Jan. 29, 2013 (available at <http://www.investmentnews.com/article/20130129/FREE/130129941#>).
- 14 National Association of Insurance Commissioners web site, Captive Insurance Companies, [http://www.naic.org/cipr\\_topics/topic\\_captives.htm](http://www.naic.org/cipr_topics/topic_captives.htm) (last updated Dec. 19, 2012).
- 15 NAIC Captives and Special Purpose Vehicle Use Subgroup of the Financial Condition Committee, Captives and Special Purpose Vehicles, NAIC Draft White Paper, Mar. 14, 2013, at 8 (available at [http://www.naic.org/committees\\_e\\_cspv\\_sg.htm](http://www.naic.org/committees_e_cspv_sg.htm)).
- 16 Leslie Scism and Serena Ng, "Regulators Probe 'Captives'," *Wall St. J.* (Aug. 5, 2012).
- 17 Lawskey, *supra* note 9; National Association of Insurance Commissioners web site, *supra* note 14.
- 18 Elizabeth Festa, "Leonardi critical of FIO's new captives task force," *LifeHealthPro*, Mar. 17, 2013 (available at <http://www.lifehealthpro.com/2013/03/17/leonardi-critical-of-fios-new-captives-task-force>).