

PROPOSED REVISION OF REINSURANCE COLLATERALIZATION REQUIREMENTS: SHOWDOWN AT THE REINSURANCE CORRAL

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Recent years have seen an increased focus on review of the collateralization requirements applicable to credit for reinsurance written by unauthorized alien reinsurers in the United States in those states that have adopted the NAIC's Credit for Reinsurance Model Law and Regulation. The issue has been hotly debated within the Reinsurance Task Force of the NAIC, which in March of 2004 formed an ad hoc committee, the Reinsurance Collateralization Roundtable (the "Roundtable"), to review the issue and prepare informal recommendations for consideration by the Task Force. The Roundtable was tasked with answering the following question: "Is there a technically sound alternative to the current 100% collateralization requirement imposed on unauthorized alien reinsurers operating in the U.S. market?"¹ In response to this question, the Task Force prepared a written report detailing two alternative proposals for reform of the collateralization requirement called the "Rating Proposal" and the "Pooling Proposal."² Both proposals have at their core the beliefs that the current system of requiring 100% collateralization for purposes of credit for reinsurance should be changed and that any proposal for change should be "geographically agnostic," and should apply equally to all alien reinsurers regardless of their country of domicile.³ The proposals are intended to generate savings in capital costs as a result of lower collateral requirements that will be passed on to the cedents and ultimately to the primary policyholders.⁴

At the end of its session at the Spring 2006 NAIC meeting, the Task Force adopted a motion that the Task Force and interested parties should focus on the Rating Proposal from the Roundtable as a possible framework for action. Various interested parties have taken conflicting positions regarding the wisdom of the proposals included in the Roundtable Report. Groups representing ceding insurers, including the American Insurance Association (AIA), the National Association of Mutual Insurance Companies (NAMIC), and the Property Casualty Insurers of America (PCI), as well as the National Conference of Insurance Guaranty Funds (NCIGF), have spoken out against the proposals, arguing that eliminating the full collateralization requirement threatens the solvency of the primary insurance market in the United States. Conversely, alien reinsurers argue that reinsurance capacity can be enhanced and capital can be freed for other purposes if the collateralization requirements are reformed, and that the current collateralization scheme is discriminatory and presents a barrier to competition in the American market not applicable to domestic reinsurers. This article will present an overview of the NAIC's current model law regarding credit for reinsurance, the rating and pooling proposals offered by the Roundtable, and a summary of the various industry positions regarding the proposals. These issues are particularly timely as the Task Force has indicated that it seeks to present a final proposal regarding the collateralization requirements for unauthorized insurers at the Winter 2006 meeting of the NAIC. As the market share of unauthorized reinsurers continues to grow,⁵ regulatory counsel would do well to familiarize themselves with this increasingly important issue.

The NAIC Credit for Reinsurance Model Law

The stated purpose of the NAIC's Credit for Reinsurance Model Law is "to protect the interest of insureds, claimants, ceding insurers, assuming insurers and the public generally."⁶ To this end, "[c]redit for reinsurance shall be allowed a domestic ceding insurer as either an asset or a reduction from liability on account of reinsurance ceded only when the reinsurer meets the requirements" of the Model Law.⁷ The Model Law permits credit for reinsurance that is ceded to an assuming insurer that is licensed to transact insurance or reinsurance in the applicable state, to an assuming insurer that is accredited as a reinsurer in the applicable state, or to an assuming insurer that is domiciled in or enters the United States through a state that employs adequate standards regarding credit for reinsurance, with no separate trusting requirement.⁸ Alternatively, a ceding insurer may obtain credit for reinsurance written by a reinsurer that maintains "a trust fund in a qualified U.S. financial institution ... for the payment of the valid claims of its U.S. ceding insurers, their assigns and successors in interest."⁹ While the form of the trust will depend upon the type of assuming insurer, the "trust fund for a single assuming insurer shall consist of funds in trust in an amount not less than the assuming insurer's liabilities attributable to reinsurance ceded by U.S. ceding insurers, and, in addition, the assuming insurer shall maintain a trustee surplus of not less than \$20,000,000."¹⁰ The form of the trust must be approved by the relevant insurance commissioner and must contain certain mandatory provisions regarding the enforcement of contested claims in the United States.¹¹ The trust must "remain in effect for as long as

the assuming insurer has outstanding obligations due under the reinsurance agreements subject to the trust.”¹² A reduction from liability of the ceding insurer also may be permitted if the requirements of Section 2 of the Model Law are not met, where security in a trust is specifically held by or on behalf of the ceding insurer and is held in the form of cash, securities listed by the Securities Valuation Office of the NAIC and qualifying as admitted assets, certain letters of credit from qualified U.S. financial institutions, or any other form of security acceptable to the relevant insurance commissioner.¹³

The Rating Proposal

The Roundtable’s rating and pooling proposals aim to change the 100% trusting requirement imposed by the NAIC’s Credit for Reinsurance Model Law. The Roundtable’s first suggested alternative to the 100% collateralization requirement in the current Credit for Reinsurance Model Law is its “Rating Proposal.” The Roundtable noted that, “[a]lthough complete consensus among all members of the Roundtable was never achieved, there was substantial agreement that a system for rating unauthorized reinsurers according to financial strength and reliability was feasible, and that collateralization requirements could be varied according to the ratings.”¹⁴ The stated purpose of the Rating Proposal is “[t]o establish new regulatory requirements that will provide reasonable and prudent controls over the reinsurance credit risk exposure of U.S. ceding insurers.”¹⁵

The Rating Proposal would create an organization called the Reinsurer Rating Organization (RRO) to rate the financial strength of reinsurers that conduct business in the United States.¹⁶ Reinsurers would be rated on a scale of 1 through 5, and each rating would have a corresponding collateral requirement, expressed as a percentage of the reinsurer’s gross liabilities.¹⁷ Reinsurers would be required to hold acceptable collateral either in the form of funds held by or on behalf of the ceding insurer in the United States and subject to withdrawal solely by the ceding insurer, or in the form of funds held in trust in a qualified U.S. financial institution for the benefit of all of the assuming reinsurer’s U.S. ceding insurers. Security may be in the form of cash, securities listed and rated NAIC 1 by the Securities Valuation Office of the NAIC and qualifying as admitted assets, certain letters of credit issued or confirmed by a qualified U.S. financial institution, or other forms of security acceptable to the RRO. Ceding insurers in the United States will be authorized to claim reinsurance recoverables from rated reinsurers as an asset or deduction from liabilities so long as the reinsurers meet the applicable collateral requirements imposed by the RRO and the other general requirements applicable to the content of the reinsurance agreements. Ceding insurers also may demand additional collateralization from reinsurers as part of their reinsurance agreements. Ceding insurers that use reinsurers that are not rated by the RRO will continue to receive annual statement credit, but only to the extent that collateral is provided by the reinsurer.¹⁸ The RRO rating system will apply to both domestic and alien reinsurers, and will apply prospectively to reinsurance contracts that are effective on or after the date that the Rating Proposal becomes effective.¹⁹

To be rated by the RRO, a reinsurer would be required to submit, among other things, an application form, certified or audited financial statements for the last three years, certification of any ratings issued for the reinsurer by a nationally recognized statistical organization, a submission to the jurisdiction of U.S. courts and appointment of an agent for service of process in the United States, biographical information on officers and directors, a listing of all reinsurance contracts entered into with U.S. cedents, a list of all disputed or overdue reinsurance claims, and any other information that the RRO may reasonably require.²⁰ Rated reinsurers also would be required to file updated financial information with the RRO on a quarterly basis, and must immediately advise the RRO of any changes in ratings by a nationally recognized statistical organization, domiciliary license status, or officers and directors.²¹

Based on the information supplied by the reinsurer and any other available information, the RRO would first determine whether the reinsurer is “reliable and of sound financial condition.”²² Assuming that this standard is met, the RRO would assign a rating to a reinsurer based upon the following criteria:

- Ratings issued to the reinsurer by nationally recognized statistical organizations;
- The overall financial strength of the reinsurer;
- The strength of financial solvency regulation in the reinsurer’s jurisdiction of domicile;

- The length of time that the reinsurer has actively traded with United States ceding insurers;
- The reinsurer's reputation for prompt payment of valid claims under reinsurance agreements, including the proportion of the reinsurer's obligations that are more than 90 days past due;
- The reinsurer's demonstrated commitment to accessibility to insurance regulators in the United States; and
- Other factors deemed appropriate by the RRO.

The Roundtable did not reach any conclusions as to the specific rating that would be assigned based upon these factors.²³ Once an initial rating is established by the RRO, that rating would be subject to change on a quarterly basis, based on the information the reinsurer provides in its quarterly updates to the RRO, and would be re-evaluated, at minimum, on an annual basis, based on annual reapplication materials.²⁴ If a reinsurer's rating improves, it would be permitted to meet the reduced collateralization requirements applicable to its new rating, on a prospective basis. If a reinsurer's rating worsens, it would be required to meet the enhanced collateralization requirements for both existing and new contracts. Ceding insurers, however, would be permitted to take full annual statement credit for all reinsurance ceded to a reinsurer that experiences a downgrade in rating for three months after that downgrade.²⁵

The Pooling Proposal

In addition to the Rating Proposal, the Roundtable "also considered a second feasible, but less popular, proposal for the creation of a common collateralization pool in place of the current company-specific 100% collateralization requirement."²⁶ The Roundtable described the Pooling Proposal, which would serve not as a replacement to current collateralization requirements, but rather as a supplement to them, as follows:

The concept calls for the creation of a single, mutualized pool of capital (Pool) that will be used to collateralize a portion of U.S. liabilities of unauthorized reinsurers that choose to participate in the Pool, where participating reinsurers shall be jointly and severally liable. The traditional methods of collateralization shall continue to be available to unauthorized reinsurers that choose not to participate in the pool as the pool is not intended to be the exclusive means whereby unauthorized reinsurance recoverable would qualify for financial statement credit.²⁷

The Pool would be formed by unauthorized reinsurers only, and would be headquartered in the United States. The initial capitalization of the Pool would be determined by an actuarial analysis, performed by U.S. regulators, of the level of funding needed in the Pool to collateralize all U.S. liabilities of unauthorized insurers. The level of funding will be expressed as a percentage of all outstanding U.S. liabilities of participating unauthorized reinsurers, less any liabilities that are collateralized outside the Pool. The actuarial analysis will be revised on an annual basis and capitalization will be amended to conform to the new annually revised figures.²⁸ The Pool will hold assets in the form of cash, securities listed and rated NAIC 1 by the Securities Valuation Office of the NAIC and qualifying as admitted assets, or certain letters of credit issued or confirmed by a qualified U.S. financial institution. Any unauthorized reinsurer that is not in liquidation or rehabilitation and does not have judgments in default would be eligible to participate in the Pool, and would contribute its proportionate share of outstanding U.S. liabilities to the Pool.²⁹ The Pool would submit quarterly reports to U.S. regulators regarding its membership status, outstanding U.S. liabilities, disputed and overdue reinsurance claims of each member, and its total assets.³⁰

Industry Positions

Reaction to both the Rating and Pooling Proposals has been mixed. Those that support the Rating Proposal have argued that the proposal establishes a level and competitive playing field, lowers collateralization costs and addresses the substantial opportunity costs of underutilized financial resources, allows the ceding insurer flexibility to determine whether to accept the collateralization level determined by the RRO or demand additional collateral, improves the ability of ceding companies to make informed decisions about reinsurers, and increases collateral

protections for ceding companies that obtain reinsurance from domestic reinsurers who will also be subject to rating.³¹ On the other hand, parties critical of the Rating Proposal argue that it exposes ceding companies to greater risk of default by rated reinsurers, makes an unrealistic assumption that a reinsurer that experiences a downgrade in rating will provide additional collateral, creates an incentive for domestic reinsurers to relocate to other jurisdictions with more favorable tax environments, creates additional administrative cost in operating the RRO that may equal or exceed any savings realized from reducing collateralization requirements, could adversely impact the state guaranty funds, and could result in interference with market pricing.³²

Supporters of the Pooling Proposal claim that it keeps the current regulatory framework for licensed reinsurers intact, ensures that default risk is retained by unauthorized reinsurers, and it is easier to administer and places fewer burdens on U.S. regulators than the Rating Proposal. Opponents of the Pooling Proposal argue that it could result in adverse selection, might result in a very small assessment base, could result in uncapped contributions to the Pool, and does not contain enhanced financial reporting requirements.³³

Conclusions

It appears that the NAIC Reinsurance Task Force will focus particularly on the Rating Proposal in its upcoming discussions of reforming the collateralization requirement for unauthorized alien reinsurers. Any such discussion must have at its core the protection of solvency of ceding companies, the interests of policyholders, and the fair treatment of reinsurers. As the debate regarding the proposals prepared by the Roundtable continues, industry stakeholders must closely monitor proposed amendments to the Credit for Reinsurance Model Law and Regulations, and analyze the impact that those amendments will have on company operations and the industry as a whole.

Endnotes

¹ Reinsurance Collateralization Roundtable, Report of the Co-Chairs, September 27, 2005, at 3. (hereinafter “Roundtable Report”).

² Roundtable Report at 3.

³ *Id.* at 4.

⁴ *Id.* at 16, 22.

⁵ As the Roundtable Report notes: “It is clear that unauthorized reinsurers domiciled outside the United States increasingly service the American insurance industry. The portion of U.S. reinsurance premium that goes to unauthorized alien reinsurers has grown an average of over 30% annually since 2000. NAIC data for 2004 shows 37% of reinsurance cessions by U.S. domestic companies, nearly \$52 billion, went to unauthorized alien reinsurers in that year.” Roundtable Report at 5.

⁶ NAIC Credit for Reinsurance Model Law, Section 1. The NAIC also has published a Credit for Reinsurance Model Regulation that provides further detail regarding the form of trust agreements and letters of credit.

⁷ NAIC Credit for Reinsurance Model Law, Section 2.

⁸ *Id.*, Section 2(A)-(C).

⁹ *Id.*, Section 2(D)(1).

¹⁰ *Id.*, Section 2(D)(3)(a).

¹¹ *Id.*, Section 2(D)(2).

¹² *Id.*, Section 2(D)(2)(c).

¹³ *Id.*, Section 3.

¹⁴ Roundtable Report at 3.

¹⁵ *Id.* at 16, Annex A.

¹⁶ *Id.* at 11.

¹⁷ *Id.* at 16-17, Annex A. The Roundtable did not set forth the specific percentages that would apply to each rating category, and instead left this issue for future discussion.

¹⁸ *Id.* at 17, Annex A.

¹⁹ *Id.* at 18, Annex A.

²⁰ *Id.* at 18-19, Annex A.

²¹ *Id.* at 20, Annex A.

²² *Id.* at 19, Annex A.

²³ *Id.*

²⁴ *Id.* at 20, Annex A. The RRO also could withdraw a reinsurer's rating if the reinsurer fails to meet the minimum requirements for rating or demonstrates lack of ability or willingness to meet its contractual obligations.

²⁵ Roundtable Report at 21, Annex A.

²⁶ *Id.* at 3.

²⁷ *Id.* at 22, Annex B.

²⁸ *Id.* at 23, Annex B.

²⁹ *Id.* at 24, Annex B.

³⁰ *Id.* at 25, Annex B.

³¹ *Id.* at 12.

³² *Id.* at 12-13.

³³ *Id.* at 14.