

RISK-BASED REINSURANCE COLLATERAL REQUIREMENTS: A NEW ERA?

(FORC Journal: Vol. 18 Edition 1 - Spring 2007)

Francine L. Semaya, Esq.
(732) 241-8090

During the December 2006 Winter National Meeting of the National Association of Insurance Commissioners (“NAIC”), the NAIC Reinsurance (E) Task Force (the “Task Force”) was presented with a proposal to change the current reinsurance collateral requirements for domestic and foreign reinsurance companies. The proposal, adopted by the Task Force, would change the collateral rules by focusing on the financial strength of reinsurers doing business in the U.S., rather than fixing collateral requirements based exclusively on licensure and accreditation status.

This proposal has been met with opposition by parties interested in preserving the current collateral requirements and with support from parties interested in amending the regulatory system governing domestic and foreign reinsurers. This article explores the current collateralization requirements, the history and substance of this proposal, and the arguments made in favor of and against amending the U.S. reinsurance collateral requirements.

Regulation of Reinsurance

In general, reinsurance is regulated with an almost exclusive focus on the cedent company’s solvency, the financial condition of the ceding company, and the financial impact on insurance consumers. Regulatory scrutiny is limited to financial condition and solvency, rather than incorporating rate and form filing protections and other regulatory requirements¹ typical of insurance regulation in the U.S., because “a reinsurance contract is entered into between two sophisticated parties each of which is fully aware of the risks and rewards associated with such contract.”²

Thus, “consumers” of reinsurance are more typically able to fend for themselves and do not warrant the intense regulatory protections imposed throughout primary insurance regulation.

Collateral Requirements:

U.S. regulators actively supervise the solvency of U.S. authorized reinsurance companies. The regulator in the state of domicile for a U.S.-based reinsurer, or in the state of entry for U.S. branches of alien reinsurers, conducts financial examinations to assess the solvency of the reinsurer. This is frequently referred to as the “direct” approach to reinsurance regulation.

Regulators also take an “indirect” approach to regulate authorized and unauthorized assuming reinsurers by controlling the statutory credits granted to U.S. ceding insurance companies on their balance sheets and income statements for risk transferred via reinsurance. Under the various state Credit for Reinsurance Laws and Regulations, a U.S. ceding company will be granted credit for reinsurance ceded, as an asset on its balance sheet or as a reduction from liabilities (hereinafter referred to as “credit”), provided that one of the following requirements is met:

1. The reinsurance is ceded to an assuming reinsurer that is licensed to transact business in the same state of domicile as the ceding company.³

FEDERATION OF REGULATORY COUNSEL, INC.

2. The reinsurance is ceded to an assuming reinsurer that is accredited as a reinsurer in the same state of domicile as the ceding company.⁴
3. The reinsurance is ceded to an assuming reinsurer that is licensed to transact business in a state with credit for reinsurance standards that are substantially similar to the cedent's state of domicile.⁵
4. The reinsurance is ceded to an assuming reinsurer that provides collateral in the form of a multi-beneficiary trust.⁶
5. The reinsurance is ceded to an assuming reinsurer that provides collateral or other security to the ceding company.⁷

If reinsurance is ceded to an assuming reinsurer that is not directly regulated by state regulators (licensed or accredited in the ceding company's state of domicile, or licensed in another U.S. state with similar credit for reinsurance laws), the ceding company may take credit for reinsurance only if the reinsurer posts collateral for at least 100% of its gross liabilities to U.S. ceding companies. This imposes not only direct regulation of the U.S. ceding insurer, but also indirect regulation on unauthorized non-U.S. reinsurers as an alternative to submitting to full regulation under the states' licensing/accreditation requirements, as unauthorized reinsurers satisfy the state regulator's collateral requirements.

NAIC Proposal to Amend Collateral Requirements

In March of 2006, the NAIC Executive Committee directed the Task Force to:

...develop alternatives to the current reinsurance regulatory framework, including the use of collateral within the U.S. and abroad. Consider approaches that account for a reinsurer's financial strength regardless of domicile, i.e., state or country...

Pursuant to this charge, the Task Force considered a proposal that would change the current reinsurance collateral requirements by focusing on the financial strength of reinsurers doing business in the U.S., rather than fixing collateral requirements based exclusively on licensure and accreditation status. The proposal, entitled "NAIC Reinsurance Evaluation Office: Proposal to Grant Credit for Ceded Reinsurance," followed extensive consideration of alternatives to the current reinsurance regulatory structure. The substance of the proposal and a summary of the salient points raised in support and opposition to the proposal are presented below.

Substance of the Proposal

Current collateral rules require that reinsurance obligations assumed by unauthorized reinsurers be fully collateralized before U.S. cedent companies can take credit for the reinsurance ceded. The collateral requirements apply across the board for all assumed reinsurance obligations by unauthorized reinsurers, are wholly dependent upon the reinsurers' state or country of domicile, and in no way account for the financial condition of the assuming reinsurer. The NAIC proposal would eliminate the across the board requirement for at least 100% collateralization for all unauthorized reinsurers, and would instead require collateral from reinsurers on the basis of their financial strength relative to credit risk, adjusting the required collateralization levels accordingly.

Reinsurance Evaluation Office

The proposal also creates a Reinsurance Evaluation Office ("REO") that would develop procedures for evaluating the financial strength and operating integrity of all reinsurance companies doing business in the United States, both authorized and unauthorized reinsurers alike. The REO would assign each reinsurer a rating as a result of its evaluation, and this rating would determine the level of collateral required to be posted for reinsurance obligations assumed by the reinsurer.

FEDERATION OF REGULATORY COUNSEL, INC.

In addition to analyzing various criteria to assess reinsurers' financial strength and credit risk rating, the REO would periodically reexamine reinsurer ratings by evaluating quarterly, annual and ad hoc reports filed by reinsurers.

Rating Criteria

The REO proposal envisions the use of rating criteria that are "consistent with the standards used by markets to assess credit risk."⁸ As a result, the REO rating criteria would be pegged to the insurance financial strength ratings assigned to reinsurers by nationally recognized statistical rating organizations ("NRSRO").

Additional criteria to be used in the proposed REO assessment process would include: the strength of solvency regulation in the reinsurer's domiciliary jurisdiction; the reinsurer's risk assumption experience; the reinsurer's reputation for claims payment; and collateral requirements for unaffiliated reinsurance assumptions. These criteria are explained below.

NRSRO Ratings

A reinsurer's REO rating would be assigned as one of six "rating bands," ranging from "REO-1" to "REO-6." The primary criteria for determining a reinsurer's REO rating would be the financial strength rating assigned to the reinsurer by an NRSRO. The proposal correlates each REO rating to equivalent ratings levels used by the various NRSROs (including AM Best, Standard and Poor's, Moody's and Fitch). Rating bands REO-1 through REO-4 are presented as "secure" ratings. REO-1 is the most secure rating, with the equivalent of an AM Best ("Best") rating of A++. Bands REO-5 and REO-6 are categorized as "vulnerable" ratings, with REO-6 having an equivalent Best rating of C, C-, D, E, or F.

For reinsurers with inconsistent ratings from multiple NRSROs, the REO rating would reflect the rating given by the majority of the NRSROs.

Insolvency Regulation in Domiciliary Jurisdiction

Although the REO rating is initially tied to the NRSRO rating, the REO may adjust the rating higher or lower than the corresponding NRSRO rating based upon other factors, including the strength of existing financial solvency regulation in the reinsurer's jurisdiction of domicile.⁹

Length of Time

Another factor considered in adjusting the REO rating higher or lower than the corresponding NRSRO rating would be the length of time that the reinsurer has actively assumed risks. This time period may not be less than three years, unless specifically permitted by the REO.¹⁰

Reputation for Prompt Payment

The REO would also consider the reinsurer's reputation for prompt payment of valid claims under reinsurance agreements in assessing the reinsurer's REO rating. The analysis of the reinsurer's prompt payment trends would include consideration of the reinsurer's aging obligations or those owed to distressed companies.¹¹

Unaffiliated Reinsurance Assumptions

The last specific criterion for assessing the REO ratings are collateral requirements for unaffiliated reinsurance assumptions for certain U.S. authorized reinsurers. Although not specifically related to setting a reinsurer's REO rating, the proposal provides that collateral may be required for unaffiliated assumptions by

FEDERATION OF REGULATORY COUNSEL, INC.

U.S. authorized reinsurers unless the authorized U.S. reinsurer has an adequate secure rating, complies with U.S. capital requirements, and satisfies other specified requirements. Collateral would not be required from either U.S. authorized reinsurers for any affiliated reinsurance assumptions,¹² or for non-U.S. affiliate reinsurance assumptions of U.S. authorized reinsurers.

Discretionary Criteria

The proposal last provides that “[o]ther factors deemed appropriate by the REO” may also be considered as rating criteria.¹³

Collateral requirements

The collateral required for liabilities arising out of reinsurance agreements will depend on the reinsurer’s REO rating. The proposal sets forth minimum collateral requirements by REO rating band, expressed as a percentage of reinsurance obligations assumed from ceding companies, as follows:

1. REO-1: 0%
2. REO-2: 20%
3. REO-3: 40%
4. REO-4: 60%
5. REO-5: 80%
6. REO-6 or unrated: 100% or such higher amount as the REO may determine based upon risk of adverse loss development.¹⁴

The proposal also provides for credits to be taken by ceding companies for reinsurance secured by qualifying Multi-Beneficiary Trusts (“MBTs”).¹⁵

Reporting Requirements

The REO proposal not only rates reinsurers’ risks for the purpose of determining collateralization requirements, but also provides continued monitoring of reinsurers’ financial condition to ensure that the assigned ratings and collateral levels are appropriate for the levels of risk present. To this end, the REO requires reinsurers to report their financial condition at regular intervals and upon the occurrence of specified events as outlined below.

Quarterly Reporting Requirements

Rated reinsurers must file with the REO: a quarterly statement providing any changes to their licenses or NRSRO rating; information comparable to quarterly NAIC financial statement information; lists of all disputed and overdue claims regarding reinsurance obligations assumed from U.S. ceding companies; and “any other information that the REO may reasonably require.”¹⁶

Annual Recertification Requirements

The REO provides a minimum frequency for re-rating reinsurers. Although the proposal provides that reinsurers may be re-rated as frequently as the re-licensing period of the reinsurer’s domiciliary jurisdiction, the REO requires that reinsurers be re-certified at a minimum on an annual basis.¹⁷

Continuous Duty to Update Information

FEDERATION OF REGULATORY COUNSEL, INC.

In addition, rated reinsurers must immediately advise the REO of any changes in their NRSRO rating, domiciliary license status, or changes in directors and officers.¹⁸ The proposal provides that the REO will continuously monitor NRSRO ratings to determine if rated reinsurers' collateral amounts require adjustment.¹⁹

Change/Revocation of REO Rating

The REO proposal will preserve the authority to adjust or withdraw reinsurers' ratings if a reinsurer fails to meet the minimum requirements provided in the proposal or if the REO determines the need to reconsider the reinsurer's ability or willingness to meet its contractual obligations.²⁰

In the event that a reinsurer's rating improves, the proposal permits the reinsurer to meet the collateral requirements that correspond to the improved rating band, on a prospective basis. If, however, the reinsurer's REO rating deteriorates, the reinsurer will be required to immediately meet collateral requirements that apply to the new rating band for all existing as well as new contracts.²¹

Last, the REO proposal provides that "an appropriate appeals process" will be available to review rating decisions made by the REO.²²

Reinsurer Eligibility Requirements

The REO requirements must be satisfied by a reinsurer seeking to be rated by the REO. To be rated, a reinsurer must submit a variety of information to the REO, including, inter alia: an application and fee; audited financial statements for the past three years filed with the reinsurer's domiciliary regulator, including, when applicable, a reconciliation to U.S. accounting procedures, unless waived by the REO,²³ certification of all current NRSRO ratings issued for the reinsurer; an AR-1 Form; biographical information for the reinsurer's directors and officers; NAIC Annual Filing Blanks; a list of all disputed and overdue²⁴ recoverables; signed consent to obtain financial and operational information from the reinsurer's domiciliary regulator; a certificate of good standing; a description of the domiciliary regulatory structure; and "any other information that the REO may reasonably require."²⁵

Responses to the Proposal

Parties engaged in the debate over the REO proposal (domestic and non-authorized reinsurers, life insurers, regulators, and other interested parties) agree that both domestic and foreign domiciled reinsurers are necessary to provide the requisite capacity to meet the U.S. demand for reinsurance, and that the financial ability of the assuming reinsurance companies to meet the reinsurance obligations ceded is of vital importance. This consensus falters, however, when the parties comment on the adequacy of the new collateral requirements to improve the condition of the reinsurance marketplace.

The REO proposal has been criticized by interested parties and domestic reinsurers alike as catering to non-U.S. reinsurers by easing the collateral requirements currently applicable to these entities, while increasing the burdens and imposing collateral requirements on U.S. licensed reinsurers who already comply with stringent state regulatory requirements. Domestic insurers, reinsurers and industry associations voiced objections to the proposal and provided comments including, inter alia, that the proposal:

- is unnecessary and imposes excessive new collateral requirements;
- is under-inclusive, fails to address alternatives other than the ratings proposal, and ignores other relevant risk factors;
- weakens critical solvency protections by relaxing collateral requirements of reinsurers over which the U.S. regulators have no oversight;

FEDERATION OF REGULATORY COUNSEL, INC.

- devalues a U.S. license by removing incentives and protections formerly available as a result of a domestic license;
- involves an unconstitutional delegation of authority to a non-governmental body;
- is too imprecise and lacks the necessary specificity;
- reduces overall reinsurance capacity and harms the market;
- is unnecessary as the current regulatory system is not in need of fixing; and
- fails to address withdrawal of a rated reinsurer and what collateral requirements would remain upon a reinsurer's refusal to be re-rated.²⁶

Non-U.S. reinsurance companies and certain industry associations, on the other hand, expressed support for the collateral proposal, stating in comment letters that, inter alia, the proposal:

- regulates all reinsurers based on their financial strength, rather than merely by state or country of domicile;
- provides options to either be rated or to comply with the 100% collateral rule; and
- provides a single regulator for assessing credit risk of reinsurers.²⁷

The non-U.S. reinsurance companies and industry associations further suggested improvements to the proposal, including, inter alia, changes to the:

- rating band and collateral requirements applicable to each band; and
- financial reporting requirements to accept suitable financial reports prepared under non-U.S. accounting standards.²⁸

Comments received from the NRSROs provide suggestions for restating the REO rating bands to more accurately track the credit ratings listed by the NRSROs, with support expressed by both domestic and non-U.S. reinsurers as well.²⁹

Most interesting was the strong consensus among state regulators that the credit for reinsurance regulatory scheme needs revision. Up until the time that the Task Force was charged to study the current reinsurance collateral requirements, state regulators almost unanimously supported the requirements for at least 100% collateral from non-U.S. reinsurers.

With increasing pressure from U.S. domiciled insurance companies with non-U.S. affiliates, the handling of reinsurance under the new E.U. rules and the need to be a player in the global markets, the NAIC and state regulators had no choice but to consider and recommend changes to the credit for reinsurance requirements. Without pressure from these outside sources, the NAIC might not have moved as quickly as it has.

Status of the Proposal

The Task Force received the REO proposal at the Winter National Meeting along with the variety of comments posited by the industry and interested parties. The Task Force, after testimony by interested parties, adopted the recommendation that the NAIC regulation of reinsurance procedures be amended to focus on broad-based risk and credit criteria, rather than focusing solely on U.S. licensure status. The Task Force adopted the further recommendation that the REO proposal be the basis of a risk-based evaluation process to be further refined by the E-Committee by September 2007. A revised proposal is expected to be adopted during the current calendar year.

Once adopted, those in favor and against the REO proposal, as adopted by the NAIC, will have ample opportunity to support, oppose, and recommend changes before each state legislature. The problem, however, is going to be when some states adopt a new regulatory scheme for collateralization, while others do not.

Endnotes

1. For example, reinsurance agreements must provide an actual transfer of risk, contain an insolvency clause, and reinsurers must provide an agent for service of process and submit to U.S. choice of law and court.
2. NAIC Reinsurance (E) Task Force, U.S. Reinsurance Collateral White Paper (March 5, 2006).
3. V NAIC Model Laws, Regulations and Guidelines §2(A), 785-1, Credit for Reinsurance Model Law (1996).
4. Id. at §2(B)(1). An accredited reinsurer is one that:
files an AR-1 Form evidencing the reinsurer's submission to the state's jurisdiction and authority; is licensed to transact reinsurance in at least one state; files a copy of its annual statement and its most recent audited financial statement in cedent's state of domicile; and maintains an adequate policyholder surplus. V NAIC Model Laws, Regulations and Guidelines §5, 786-1, Credit for Reinsurance Model Regulation (2006).
5. Id. at § 6. The assuming reinsurer must also maintain a policyholder surplus of \$20,000,000 and must file an AR-1.
6. NAIC Reinsurance (E) Task Force, U.S. Reinsurance Collateral White Paper (March 5, 2006).
7. Id.
8. § 2, NAIC Reinsurance Evaluation Office Proposal to Grant Credit for Ceded Reinsurance, NAIC, Dec. 10, 2006.
9. Id. at § 3(B)(II).
10. Id. at § 3(B)(III).
11. Id. at § 3(B)(IV). Section 3(B)(IV) provides that the analysis of the reinsurer's reputation for prompt payment of valid claims may include:
...the proportion of the reinsurer's obligations that are more than 90 days past due or are in dispute, including receivables payable to companies that are in Administrative Supervision or Receivership.
12. Id. at § 3(B)(V). Section 3(B)(V) provides:
For U.S. authorized reinsurers collateral will not be required for unaffiliated assumptions if the U.S. authorized reinsurer is rated REO 1, 2 or 3, is in compliance with applicable U.S. capital requirements, and has a minimum financial strength which may include selected financial leverage ratios (e.g. net liabilities to surplus) as established in these regulations and has a history of promptly paying claims...
13. Id. at § 3(B)(VII).
14. Id. at § 4(B)(I).
15. Section 3(B)(VI)(ii) of the REO proposal provides that groups of reinsurers (including both affiliated groups and Lloyd's) maintaining multi-beneficiary trusts shall receive a rating based on the overall financial strength of the group. The proposal, however, provides that each member or Lloyd's syndicate must submit a separate application to the REO.

FEDERATION OF REGULATORY COUNSEL, INC.

16. Id. at § 4(C)(I).
17. Id. at § 4(D).
18. Id. at § 4(C)(II).
19. Id. at § 4(D)(I).
20. Id. at § 4(E)(I).
21. Id. at § 4(E)(III). Despite the downgrading of the reinsurer's REO rating, U.S. ceding companies may continue to take previously allowed credit for reinsurance obligations ceded to such reinsurer for a period of three months, unless the reinsurance is deemed uncollectible.
22. Id. at § 4(E)(IV).
23. Id. at § 3(A). A reinsurer must submit audited financial statements for the past three years: ...pursuant to or including a reconciliation to U.S. GAAP or U.S. Statutory Accounting Principles. Id.
24. Recoverables more than ninety days past due are considered overdue.
25. Id. at § 3(A).
26. Various comment letters contained in the Minutes of the NAIC Reinsurance "E" Task Force Dec. 9 and Dec. 11, 2006.
27. Id.
28. Id.
29. Id.