

FEDERATION OF REGULATORY COUNSEL, INC.

**NEW PERSPECTIVES ON REINSURANCE COLLATERAL
REQUIREMENTS**

(FORC Journal: Vol. 20 Edition 3 - Fall 2009)

Richard J. Fidei, Esq.
(954) 492-4010

Fred E. Karlinsky, Esq.
(954) 492-4010/(954) 332-1749

After years of discussion and different iterations, in December 2008, the National Association of Insurance Commissioners ("NAIC") adopted the Reinsurance Regulatory Modernization Framework (the "Framework"). This Framework would modernize and dramatically alter the current state-based regulation of reinsurance. Since the conceptual framework requires federal legislation to implement its objectives, the Reinsurance Task Force (the "Task Force") of the NAIC issued an exposure draft of proposed federal legislation on March 24, 2009. The Reinsurance Regulatory Modernization Act of 2009 (the "Modernization Act") has since been subject to significant public comment. On July 27, 2009, the Task Force exposed a revised draft of the Modernization Act for further public comment, after incorporating and addressing a number of the comments it received. Additional comments were due by August 17, 2009.

Background

Under current United States credit for reinsurance rules, insurers are permitted to take credit on their financial statements for the reinsurance they cede, if the assuming reinsurer is authorized or accredited in the state of the ceding insurer. If the reinsurer is not authorized or accredited, it is unauthorized and is required to post appropriate collateral equal to 100% of its gross actuarially estimated reinsurance liabilities. State authorization or accreditation of a reinsurer requires an application process and subjects the reinsurer to the state's jurisdiction and some of its laws and regulations. Many insurers do not wish to be subject to this process and these requirements for a variety of reasons, including tax consequences applicable to certain alien reinsurers.

Alien reinsurers have particularly denounced these collateral requirements, arguing that they tie up capital, create significant costs for doing business in the United States, and place them at a disadvantage against their United States competitors, who are not necessarily burdened by the same requirements in non-U.S. jurisdictions. Some alien insurers and reinsurers operate through United States subsidiaries in order to avoid these onerous requirements. Critics of the current system also argue that restricting availability of capital from alien reinsurers limits competition. Of course, this could theoretically affect pricing for reinsurance.

Some insurers are in favor of keeping the current credit for reinsurance rules because the required posting of collateral provides security to the ceding insurer. If the reinsurer is not required to post collateral, solvency issues related to the collection of reinsurance recoverables would be implicated and, at the least, it is feared that collection could be compromised by shifting negotiating leverage to the benefit of the reinsurer, especially if the reinsurer is located in a foreign country.

Another issue involves the equities of the requirement to post collateral. Alien reinsurers are not necessarily subject to United States tax laws, which are generally imposed on U.S. domiciled reinsurers. This tax insulation has been used as partial justification that it is fair to impose collateral requirements on alien reinsurers. To the extent alien reinsurers are not required to post collateral to engage in reinsurance in the United States, some domestic insurers argue this, along with the continuation of the tax exemption, will

FEDERATION OF REGULATORY COUNSEL, INC.

provide the alien reinsurers with an unfair competitive advantage.

Summary of Proposal

The United States, which is the largest reinsurance market in the world, is the only major market that imposes such collateral rules. Some in the insurance industry believe the time is ripe for change. In 2007, the NAIC charged the Task Force with the responsibility of considering alternatives to the current regulatory framework which provides credit for reinsurance. Specifically, the Task Force was asked to develop methods of assessing the strength of reinsurers, regardless of their state or country of domicile. Subsequently, the Task Force studied and considered a ratings-based system that would serve to supplement or replace current collateral requirements for foreign and alien reinsurers. Under a ratings-based system, a regulatory system would be established that would require the reinsurer to post collateral based on the financial strength of a reinsurer, the depth and quality of regulatory oversight of the reinsurer's state or country of domicile, and a variety of other factors.

The following is a brief summary of select provisions of the July 27, 2009 revised draft of the Modernization Act.

The Modernization Act proposed by the NAIC establishes two types of reinsurers in the United States: U.S. domiciled reinsurers, called "National Reinsurers," and non-U.S. reinsurers, called Port of Entry ("POE") Reinsurers ("POE Reinsurers").¹ Each type of reinsurer would be supervised by a single state: either the home state (where the National Reinsurer is licensed and domiciled) or the POE state (where a non-U.S. assuming reinsurer is certified to provide creditable reinsurance to ceding insurers).²

The Modernization Act establishes the Reinsurance Supervision Review Board (the "Board"), comprised of ten insurance regulators and five representatives of U.S. agencies as appointed by the President and with the advice and consent of the Senate.³ The Board would have the authority to evaluate the regulatory systems of the states to determine if they qualify as home states and/or POE state supervisors.⁴ The Board also has authority to evaluate reinsurance supervisory systems of non-U.S. jurisdictions to determine if they are eligible as a qualified jurisdiction under NAIC standards.⁵ The Board would also have the authority to enter into agreements with state, federal, and non-supervisory and law enforcement agencies for sharing supervisory information on a confidential basis.⁶

The Modernization Act would authorize a certification mechanism allowing states demonstrating requisite resources, expertise, and experience to regulate reinsurers on a cross-border basis to serve as the home state for U.S. domiciled reinsurers or POE state for non-U.S. reinsurers.⁷ POE state supervisors would be authorized by the Modernization Act to enter into reciprocal recognition agreements.⁸ Additionally, a POE state would be authorized to enter into information sharing agreements with qualified non-U.S. jurisdictions, in accordance with NAIC standards and procedures adopted by the Board.⁹ This authorization is intended to eliminate constitutional concerns about possible violations of the Compact Clause of the U.S. Constitution, which prohibits states from entering into "any Agreement or Compact with another State, or with a foreign Power," without the consent of Congress.¹⁰

Under the Framework and Modernization Act, reinsurers would be required to have at least \$250 million in capital and surplus for eligibility as either a National Reinsurer or POE Reinsurer.¹¹ This surplus requirement could be satisfied by a group including a number of underwriters having the required capital and surplus and a central fund of at least \$250 million.¹² In order to be certified as a POE Reinsurer, a company would be required to be organized in and licensed by an eligible non-U.S. jurisdiction.¹³ The Board would determine eligibility of non-U.S. jurisdictions.

FEDERATION OF REGULATORY COUNSEL, INC.

Credit for reinsurance ceded by a domiciled insurer to a National Reinsurer or a POE Reinsurer would be granted in accordance with the standards set forth in the Framework and Modernization Act.¹⁴ The amount of collateral a reinsurer would be required to post under the Framework would be based on an evaluation by its home state or POE state supervisor, as applicable. These supervisors would utilize standards recommended by the NAIC and adopted by the Board to determine the rating (financial strength) of a reinsurer. Ultimately, the supervisor would assign a reinsurer one of five ratings regarding the financial strength of the reinsurer. These ratings range from various levels of "secure," which would require the posting of no or staggered percentages of collateral, to "vulnerable," which would require the posting of 100% collateral.¹⁵

A home state or POE state supervisor would utilize Board approved standards which would include, among others, such considerations as:

- Financial strength ratings from at least two qualified rating agencies;
- Compliance with reinsurance contracts;
- The business practice of the reinsurer in dealing with its ceding insurers;
- For National Reinsurers, a review of the most recent NAIC Annual Statement;
- For POE Reinsurers, a review of a report filed annually in the form of the applicable NAIC Annual Statement Blank;
- The reinsurer's reputation for prompt payment of claims;
- Regulatory actions against the reinsurer;
- Report by an independent auditor on the reinsurer's financial statements;
- For POE Reinsurers, audited financial statements, regulatory filings, and actuarial opinions;
- The liquidation priority of obligations to a ceding insurer;
- A reinsurer's participation in any solvent scheme of arrangement, or similar procedure, which involves U.S. ceding insurers; and
- Any other information deemed relevant by the home state or POE state supervisor.¹⁶

Under the Framework, insurers providing reinsurance who do not choose to become National Reinsurers or POE Reinsurers would have the option of continuing to operate under the current Credit for Reinsurance Model Law, which requires the posting of 100% collateral for the reinsurer's obligations, unless the reinsurer is authorized or accredited in the applicable state.¹⁷

Ongoing Comments

The industry and other interested parties submitted a substantial number of comments to the first draft of the Modernization Act. The Modernization Act provides for different standards pertaining to the amount of collateral which must be posted by a reinsurer depending upon whether that reinsurer is a National reinsurer or POE Reinsurer. The higher rated classes of "secure" National reinsurers will not be required to post collateral, whereas those same classes of "secure" POE Reinsurers will be required to post collateral. Some have commented that the Modernization Act would afford preferential treatment to U.S. reinsurers.

Some comments focused upon possible constitutional issues related to the Modernization Act. Some interests expressed concerns with regard to the constitutionality of states entering into agreements with non-U.S. jurisdictions. Furthermore, others expressed concern that the delegation of authority to the Board would constitute an improper delegation of legislative and executive power to a private institution without federal oversight. Another constitutional argument centered upon the assertion that since Congress does not have the authority to command state action, provisions in the Modernization Act requiring state supervisors to take action with regard to capital and surplus, financial statements, and security requirements may be construed as a violation of the Constitution.

FEDERATION OF REGULATORY COUNSEL, INC.

Others expressed a more basic concern that the elimination of collateral with regard to reinsurance obligations could impair the ability of ceding insurers to collect reinsurance proceeds thereby impairing some ceding insurers who often rely on the reinsurance collateral as a security bedrock in their operations. It was pointed out by one industry association that the Oversight and Investigations subcommittee of the U.S. House Energy and Commerce Committee had concluded that the inability of U.S. insurers to collect reinsurance payments from alien reinsurers was a critical factor in the U.S. insurer insolvencies in the 1980s. This association noted that since the subsequent enactment of the credit for reinsurance laws, the failure to collect reinsurance recoverables has not been a critical factor in any U.S. insolvencies.

Specific State Action

Some states have decided to take action without waiting for a resolution of the issue by the NAIC and the Federal Government. For example, on September 16, 2008, Florida adopted a new regulation that authorizes the Insurance Commissioner to establish lower collateral requirements for unauthorized and unaccredited foreign and alien reinsurers that have financially secure ratings from at least two nationally recognized rating organizations and meet certain eligibility standards, such as maintaining surplus over \$100 million and being authorized in their domiciliary jurisdiction for the types of insurance to be ceded.¹⁸ After eligibility is determined, the amount of collateral the reinsurer is required to post is determined by the Rule, which contains a schedule. The higher a reinsurer's financial strength rating, the less collateral the reinsurer is required to post. Florida's ratings-based collateral rule applies only to reinsurance ceded by Florida domestic property and casualty insurers.

On December 24, 2008, the New York State Insurance Department (the "Department") published its proposed tenth amendment to a regulation relating to the ratings-based reinsurance collateral issue.¹⁹ Although similar to the NAIC proposal, the New York regulation applies only to non- U.S. reinsurers. Like the Florida rule, the New York regulation sets collateral based on reinsurer financial strength ratings from at least two recognized rating agencies; however, it requires the unauthorized assuming reinsurer to maintain a minimum net worth of \$250 million and to be authorized by, and meet solvency and capital standards of, its domiciliary jurisdiction. The highest rated reinsurers would not be required to post any collateral, while lower rated reinsurers would be required to post collateral ranging from 10% to 100% of their reinsurance obligations. Although the New York regulation was originally set to be effective July 1, 2009, the Department has advised that it is in the process of reviewing and evaluating public comments and does not expect the regulation to take effect prior to January 1, 2010.

Conclusion

The issues raised with regard to the efforts to modernize the collateral requirements obligation under reinsurance contracts and the numerous comments which have been submitted to the NAIC by the industry and the other interested parties evidence the significance of the subject to the industry. It is expected that significant discussion will continue on the Modernization Act and that the Task Force will need to further revise the Modernization Act. At the time this article was prepared, the Task Force had just released its most recently revised exposure draft of the Modernization Act. The Task Force has indicated that it is accepting further comments to the exposure draft and will announce plans for future discussion.

Endnotes

1. The Reinsurance Regulatory Modernization Act of 2009 § 2 (The National Association of Insurance Commissioners Tentative Revised Draft July 27, 2009) (hereinafter Modernization Act).

FEDERATION OF REGULATORY COUNSEL, INC.

2. *Id.* §§ 4, 10(10), (18).
3. *Id.* § 2.
4. *Id.* § 2(a).
5. *Id.* § 2(b).
6. Modernization Act, *supra* note 1, § 2(d).
7. *Id.* § 4.
8. *Id.* § 4(h).
9. *Id.* § 2(c).
10. U.S. Const. art. 1, § 10, cl. 3.
11. Modernization Act, *supra* note 1, § 5(a).
12. *Id.*
13. *Id.* § 10(17).
14. *Id.* § 5(b).
15. *Id.*
16. Modernization Act, *supra* note 1, § 5(b)(4)(A)-(L).
17. *See id.* § 6.
18. Fla. Stat. § 624.610 (2007); Fla. Admin. Code Ann. r. 69O-144.007.
19. Tenth Amendment to N.Y. Comp. Codes R. & Regs. tit. 11, § 125 (Regulation No. 20).