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SECURING REINSURANCE: LETTERS OF CREDIT AND REGULATION 114 TRUSTS

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Reinsurance obligations can be secured in a number of ways, including trust agreements, letters of credit, funds on deposit accounts, funds withheld arrangements and pledges. Reinsurers are not subject to direct regulation, but in order for a U.S. insurer to obtain credit for reinsurance, the assuming reinsurer must be authorized or accredited in the ceding insurer's jurisdiction, or the reinsurer must post collateral in an amount equal to 100% of gross liabilities in accordance with applicable law.

The current global economic and credit environment has made it difficult and costly to collateralize insurance programs. At the same time, the risk of default by reinsurers and banks, which cannot always be accurately assessed, is a significant concern. As a result, insurers' interest in risk-funding methods, including the security offered by methods such as "Regulation 114 Trusts," named for Regulation 114 of the Official Compilation of Codes, Rules and Regulations of the New York State Insurance Department (NYSID),[1] has skyrocketed.

This article addresses security for reinsurance and focuses on two of the most widely accepted methods by which U.S. insurers may obtain credit for reinsurance from unauthorized reinsurers: letters of credit (LOCs) and Regulation 114 Trusts.

Letters of Credit

Historically, letters of credit have been used to support reinsurers' obligations and have been viewed as the "best" form of collateral for reinsurance. By some estimates, three out of every four funded collateral programs use LOCs. Unauthorized reinsurers may offer LOCs for credit for reinsurance purposes, so long as the LOC is compliant with state insurance law, which typically requires an LOC with an authorized commercial bank in a prescribed form. It must be "clean," "irrevocable and unconditional," and "evergreen."[2] Even where an LOC is not required for credit for reinsurance, it may be used to secure reinsurance obligations and can be tailored to meet the specific needs of the cedent and reinsurer in a particular transaction.

Given the continuing financial market's difficulties and the resulting consolidation of the banking industry, banks have been increasingly unwilling to issue letters of credit on an unsecured basis, or to issue multi-year, *i.e.*, evergreen, letters of credit. Reinsurers have been compelled to post collateral in order to obtain LOCs, and as banks continue to reprice risk and restrict credit, the costs of LOCs continue to increase.

Regulation 114 Trusts

In lieu of an LOC, credit for reinsurance ceded to non-admitted reinsurers also is permitted where the reinsurer's obligations are secured by a compliant trust agreement. Because many U.S. insurers are licensed to do business in New York and are required to comply with Regulation 114, this article addresses trusts under New York's Regulation 114. However, such trusts are permitted by the laws of all other U.S. states under some version of the National Association of Insurance Commissioners (NAIC) model act and regulation governing credit for reinsurance.

Regulation 114 Trusts are created under a relatively standard form of tripartite agreement involving a single ceding insurance company, *i.e.* the beneficiary; a financial institution, *i.e.*, the trustee; and a single

non-admitted reinsurer, *i.e.*, the grantor, who grants the beneficiary control over the ceded premiums.[3]

Trust assets are held in a secure financial institution approved by the NAIC or in a state-chartered bank under applicable state law. The trust must be maintained onshore and must be structured so that eligible assets are held by the trustee to guarantee payment of the reinsurer's obligation.

The insurance buyer utilizes the assets held to collateralize the reinsurer's loss payment obligations, and the grantor delivers the assets to the trustee bank in an amount equal to 100% of the beneficiary's collateral requirements. The beneficiary then has the right to demand possession of the assets in the trust to either pay or reimburse the beneficiary for the grantor's loss payment obligations. The trustee cannot release the funds for any reason, other than the payment of approved claims, without the beneficiary's consent.

In short, under a trust agreement, the trust assets may not be used for any purpose, except the payment of authorized claims, without the cedent's approval and consent. The trust thus allows state regulators to monitor the ceded funds and to control those funds in the event of the insurer's insolvency.

Considerations in Using a Regulation 114 Trust

Although Regulation 114 Trusts are increasing in popularity, insurers' hesitancy in accepting a trust continues. LOCs seem to remain the preferred method of collateralization because they are well-tested and allow for the immediate withdrawal of cash. Nonetheless, in today's financial environment, insurers and reinsurers must consider the alternative of using a trust to collateralize an insurance program. In evaluating whether to use a trust, the following issues should be considered.

The Form of the Trust Agreement

Grantors often seek changes to the standard form, especially with regard to withdrawal and termination provisions, or propose to enter into "side" contracts to the trust agreement in order to meet their business objectives. However, any references to conditions or terms extraneous to the trust agreement are prohibited by law.[4]

Beneficiaries also must be wary in agreeing to any changes in the trust agreement which would impact their ability to use acceptable collateral where credit for reinsurance is required. Any amendments to the agreement which impair the ability to claim the assets as acceptable collateral must be avoided.

Acceptable Trustee Banks

Similar to an LOC, the trustee bank used for a Regulation 114 Trust must be a member of the Federal Reserve System or a New York State-chartered bank or trust company. The NAIC maintains a list of acceptable bank and trustee institutions, which generally follows accepted credit ratings of bank institutions.[5]

As an aside, it should be noted that the choice of financial institution will impact the issue of the regulation of the trustee. State chartered banks are regulated on both the state and federal levels; national banking associations are regulated on the federal level by the Office of the Comptroller of the Currency.

Acceptable Trust Assets and Investments

Trust assets must be managed and invested in "permitted investments" in accordance with the terms of the trust documents and applicable law. The NYSID requires that any and all trust assets be United States dollar denominated, so that U.S. insurers are afforded unfettered access to funds which are not subject to exchange rate fluctuations or currency blockage risk.[6]

The form of permitted investments is fairly restrictive, allowing funds to be invested only in cash and equivalents, such as certificates of deposit issued by U.S. banks, U.S. government obligations, money markets and relatively short-term, fixed instruments which are subject to NAIC investment requirements.[7] This conservative investment requirement provides more security, but results in a potentially lower rate of return on investment.

Once the assets are funded in the trust, several different investment management approaches may be selected. For example, assets can be invested in liquid money market funds without active oversight; assets also can be actively managed within the parameters of the trust agreement.

Costs and Accounting Treatment

Bank charges for LOCs typically are based on the amount of the trust and can vary, depending on the bank, the reinsurer's financial condition and credit rating, and whether the LOC is secured by cash or other collateral. Regulation 114 Trusts generally are managed on an annual, flat fee basis. Thus, the actual amount of the trust must be considered in deciding whether an LOC or a Regulation 114 Trust is more cost-effective. Trust fees will be lower than LOC charges as a general rule.

A Regulation 114 Trust may benefit solvency and financial ratio thresholds because it reduces the utilization of a company's line of credit and is accounted for as a restricted asset. An LOC, on the other hand, may encumber credit and is accounted for as a debt obligation on the corporate balance sheet, often disclosed in the "Notes to Financial Statements," with details on the amount pledged as collateral towards the LOC.

An insurer may have multiple Regulation 114 Trusts from several unauthorized reinsurers, or conversely, an unauthorized reinsurer may accept cessions from more than one insurer by establishing multiple trusts. The trust effectively segregates a program's ceded funds into a controlled account and allows regulators to review and monitor the funds available to meet ceded obligations.

Impact in the Event of Insolvency of the Reinsurer or the Trustee

A full discussion on U.S. insolvency laws is beyond the scope of this article. However, the insolvency of a reinsurer typically will not impact the bank's payment obligations to the beneficiary under an LOC. Similarly, assets in a Regulation 114 Trust are not part of the reinsurer's property to the extent of the beneficiary's interest, although access to trust assets may be delayed while the extent of the reinsurer's residual interest, if any, is determined by the appropriate court.

With respect to the insolvency of a bank, under an LOC, a beneficiary becomes an unsecured creditor. Under a trust, on the other hand, specifically segregated trust assets are assets of the beneficiary and do not become general assets of the trustee bank. This may not be true, however, with respect to cash or possible investment income, especially in those cases where the trust agreement allows for the creation of a separate income account which allows for the payment of the trustee's fees and expenses.

A Note About Other Types of Security for Reinsurance

Funds Withheld Arrangements

In a funds withheld arrangement, assets that normally would be paid over to a reinsurer are withheld by the cedent. As a result, from a cedent's viewpoint, this may be the best approach to collateralizing reinsurance obligations. Some U.S. jurisdictions may allow credit for reinsurance under these arrangements. However, the reinsurer bears the risk that an insolvent cedent will not transfer earned ceded premiums or investment returns on funds withheld.

Security Interests

A reinsurer may seek to secure its reinsurance obligations through a pledge or charge of cash or securities to the cedent. The parties can negotiate their rights to the pledged or charged assets and interest earned, the investment criteria and discounts applicable in respect of the pledged or charged assets, and the circumstances triggering the right of the cedent to take control of the pledged or charged assets, or for the reinsurer to withdraw some or all of the collateral. These types of arrangements are not acceptable for securing the obligations of unauthorized reinsurers under current U.S. credit for reinsurance rules.

"Downgrade Triggers"

Another approach to be considered is the inclusion of a "downgrade trigger" in the reinsurance agreement, which will trigger collateralization in the event of a reinsurer downgrade. Whether these provisions provide effective protection is of some concern because they can result in the further deterioration of the reinsurer's financial condition. As a result, a downgrade trigger may provide the cedent with no practical benefit.

Other Trust Agreements

Finally, because Regulation 114 Trusts must include required provisions and permit unrestricted withdrawals by the cedent, they may be unattractive to reinsurers since they do not provide any security to the reinsurer and allow cedents to withdraw funds at any time. Where credit for reinsurance is not an issue, cedents and reinsurers may negotiate other types of trust agreements to secure reinsurance obligations with a financial institution serving as trustee, agreeing upon the terms of the distribution or release of funds.

The Potential Impact of Changes to U.S. Collateral Requirements for Reinsurance

Last year, the NAIC approved the submission to Congress of the Reinsurance Regulatory Modernization Act of 2009 (the NAIC Act). The NAIC Act seeks to reduce the amount of collateral that reinsurers must post in order for U.S. ceding insurers to receive credit for reinsurance. It calls for a sliding scale of collateral requirements based on reinsurers' credit ratings. Similar proposals have been advanced in New York, Florida and Texas.

The NAIC Act contemplates the creation of a new federal agency, the Reinsurance Supervision Review Board (Review Board), which would determine, under NAIC-recommended standards, which states qualify as "Home State" supervisors for U.S. domestic insurers, or "Port of Entry" supervisors for non-U.S. insurers. Under the proposal, no state may impose different collateral standards in order for an insurer to receive credit for reinsurance ceded to a Port of Entry reinsurer or regulate the financial condition of a Port of Entry reinsurer. Nevertheless, the NAIC Act would not preempt the authority of a U.S. ceding insurer's Home State regulator to determine what constitutes adequate collateral, compliance with applicable reinsurance risk transfer rules and the ceding insurer's incurred loss reserves, or to otherwise exercise regulatory powers not inconsistent with the NAIC Act.

If adopted, collateral equal to 100% of ceded reserves no longer will be required for the ceding company to take credit for reinsurance, and assets held in Regulation 114 Trusts may be released. However, when and if the NAIC Act will be enacted into law remains far from certain, and it will take several years after adoption to see any impact on the market.

Florida, which traditionally has had some difficulties attracting capital to the market in view of the state's hurricane exposure, enacted a similar proposal into law in 2007, effective September 16, 2008, allowing credit for reinsurance from a nonadmitted reinsurer, even if the reinsurer does not maintain 100% collateral, so long as the reinsurer meets that state's financial requirements.[8] However, the Florida statute applies only to Florida

domiciled companies.

A New York proposal, seeking to treat well-capitalized, unauthorized and unaccredited reinsurers with the highest credit rating the same as authorized and accredited companies, was advanced in 2007, but it has not been adopted pending action on the federal level.[9] A similar proposal has been discussed in Texas.

Conclusion

Economic conditions are placing increasing pressure on the purchasers of reinsurance to reduce expenses, deploy capital efficiently and manage access to credit. Insurance program collateralization requirements can represent significant costs and reduce the availability of credit to an insurer.

Cedents and reinsurers have a number of options in determining whether to secure reinsurance obligations. Parties have flexibility in structuring such arrangements, except where collateralization is required pursuant to U.S. law in order to obtain credit for reinsurance. In evaluating these options, cedents must consider the financial condition of reinsurers and trustee banks and the aggregate exposure to each, given today's uncertain financial environment.

Endnotes

1. N.Y.Comp. Codes R. & Regs. tit. 11, § 126.

2. *See*, *e.g*., N.Y. Comp. Codes R. & Regs. tit. 11, § 79.2 (Regulation 133).

3. *See* NYSID Office of General Counsel Op., dated July 21, 2005; N.Y.Comp. Codes R. & Regs. tit. 11, §§126.2 & 126.3(d) & (e).

4. *See* N.Y. Comp. Codes R. & Regs. tit. 11, §126.3 (d)(3)&(4).

5. The NAIC's recent list includes Brown Brothers Harriman; The Bank of New York; Bank of America; Citibank, N.A.; J.P. Morgan Chase, N.A.; Mellon Bank, N.A.; Deutshe Bank Trust Company; State Street Bank and Trust; and Wells Fargo Bank, N.A., among others. The trust departments of the listed institutions can be assumed to be familiar and experienced with the reinsurance trust process.

6. *See* NYSID Office of General Counsel Op. No. 08-10-09, dated October 27, 2008; N.Y. Comp. Codes R. & Regs. tit. 11, § 126.5(a)(2).

7. *See* N.Y. Ins. Law §1404.

8. 69O-144.007, F.S.

9. *See* proposed amendment to N.Y. Comp. Codes R. & Regs. tit. 11, § 125 (Regulation No. 20).