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COLLATERAL FOR REINSURANCE OBLIGATIONS

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At least two factors have led cedents and reinsurers to reconsider traditional approaches to the collateralization of reinsurance obligations in the last 18 months. First, the global recession has adversely impacted the financial condition of many international financial services groups, including both reinsurers and banks which provide letters of credit to secure reinsurers' obligations. Second, after years of industry discussions, the New York State Insurance Department (the "NYID")**1** and the National Association of Insurance Commissioners (the "NAIC")**2** have proposed modification of the U.S. approach to credit for reinsurance that would loosen the requirement of 100% collateralization by unauthorized reinsurers. It is proposed that future collateral requirements will be based on the financial strength of the unauthorized reinsurers.

In this environment, cedents should recognize that the risk of non-performance by well-rated reinsurers and banks is not insignificant. As AIG's spectacular descent from its place astride the global insurance industry to the ignominy of government control demonstrates, it may be difficult to assess accurately reinsurer default risk. At the same time, demand for letter of credit facilities has caused the cost of reinsurers to rise significantly, as a result of which reinsurers and cedents (to whom those costs are indirectly passed on) may be well-advised to develop alternative approaches to secure reinsurance obligations. Indeed, offering security to cedents in a cost-efficient way may provide reinsurers with a relative competitive advantage over those who do not.

While the adoption of proposals similar to those advanced by the NYID and the NAIC may make reinsurance more available or less costly, U.S. cedents in such a modified landscape may well face greater challenges in structuring reinsurance programs. When negotiating reinsurance treaties with unauthorized reinsurers from whom they can no longer demand full collateral as a regulatory requirement, will U.S. cedents weigh the relative financial strength of reinsurers or overall exposure of the cedent to a particular reinsurer and seek levels of security above what would otherwise be required under U.S. insurance law?

Downgrade triggers

One approach to securing reinsurance obligations is for reinsurance contracts to include provisions that trigger collateralization in the event of reinsurer downgrades. However, experience with swap obligation collateralization triggers of the non-insurance operations of AIG and Lehman Brothers, among others, raises concerns as to whether such arrangements provide effective protection.

Indeed, cascading collateral triggers can lead to a "death spiral" of the counterparty, as in fact occurred in the U.K. with Independent Insurance, which slumped from an "A" rating to insolvency in a period of three months in 2001. Insureds with policies which contained downgrade triggers never obtained collateral. A collateralization trigger imposed on a downgraded reinsurer may, due to its deteriorating financial condition or liquidity constraints, result in little practical benefit to a cedent.

Collateralization options

Reinsurance obligations can be secured through "funds withheld" arrangements, trust arrangements, letters of credit, pledges of cash or securities, or third party surety arrangements. This article addresses some of the

issues these options raise for cedents and reinsurers.

Credit for reinsurance

Every U.S. state has adopted the NAIC Credit for Reinsurance Model Law (the "Model Law") or a version of it. Under the Model Law, a U.S. cedent will get statutory credit for reinsurance if any of the following apply:

(1) the reinsurer is authorized to transact insurance in the cedent's domiciliary state;

(2) the reinsurer is accredited by the cedent's domiciliary state to transact reinsurance;

(3) the reinsurer's domiciliary state has a substantially similar credit for reinsurance law as the cedent's domiciliary state, and the reinsurer has at least $20 million in policyholder surplus;

(4) the reinsurer maintains a trust approved by the commissioner of the cedent's domiciliary state of not less than $20 million in a qualified U.S. financial institution; or

(5) the cedent maintains collateral for the reinsurer's obligation by either (a) withholding funds on deposit from the reinsurer, or (b) holding security such as a trust or a letter of credit.

Funds withheld

A funds withheld arrangement is the most favorable method of collateralizing reinsurance obligations from the perspective of a cedent. In a funds withheld arrangement there can be no lien on the assets and the cedent must have exclusive control of such assets. Such arrangements may be unattractive to reinsurers due to the risk that insolvent cedents will not transfer earned ceded premiums or investment returns on the funds withheld. Simply crediting the funds withheld to a separate account in the name of the cedent will be unlikely to provide security or priority to the reinsurer if the cedent becomes insolvent, and will require the reinsurer to establish against the liquidator that the funds are held outside the insolvent estate under an implied trust in respect of funds not required to meet claims.

Whether or not it is practical for the cedent to provide security for its obligations to transfer earned premium or income to the reinsurer after meeting claims will depend on the particular circumstances. However, a cedent must hold sufficient unrestricted assets to support the issue of a letter of credit, to pledge collateral or fund a collateral trust. To have to provide security for unpaid premium may more than offset the benefit of withholding funds for the cedent.

In some circumstances the cedent pays the premium to the reinsurer, which holds it in a separate account designated for the benefit of the cedent. That structure will not qualify for credit for reinsurance and moreover will not provide security for the cedent if the reinsurer becomes insolvent in the absence of additional documentation or circumstances establishing a security interest in, or trust over, the designated account.

Trust arrangements

As noted above under "Credit for reinsurance" paragraph (5), reinsurance obligations can be secured through a trust arrangement. U.S. insurers are familiar with a so-called "Regulation 114 trust" (the name refers to the applicable New York regulation, but similar trusts are authorized under other U.S. state insurance laws), which must include required provisions and permit unrestricted withdrawals by the cedent.[3] Such trusts are unattractive to reinsurers since, like funds withheld, they do not provide security or priority to the reinsurer for payment of premiums if the cedent becomes insolvent and withdraws funds from the trust as permitted under the regulations.[4] The reinsurer would need to establish that the funds withdrawn from the trust, which are not

required to meet claims, are subject to a constructive trust.[5]

Letters of credit

Letters of credit have been extensively used by the insurance industry to support obligations. Unauthorized reinsurers can offer them in the U.S. as alternatives to Regulation 114 trusts for credit for reinsurance purposes. However, as with Regulation 114 trusts, the form of such letters of credit is prescribed by law, and cedent rights to draw upon the letter of credit are unlimited.[6]

Letters of credit can also be effective in securing reinsurance obligations even when not required by law - they are the standard way of securing reinsurance obligations in Europe - and can be tailored to meet the specific needs of a cedent and reinsurer. However, letters of credit can generally be drawn on demand (notwithstanding the terms of the reinsurance) and are considerably more expensive than trust or pledge arrangements, since the bank is assuming personal liability for making payment to the cedent (which is not the case with a trust arrangement, where the trustee's liability would be limited to distributing the assets under its control).

In addition, over the last 18 months, banks have become reluctant to issue letters of credit on an unsecured basis and to issue multi-year or so- called "evergreen" letters of credit, unless mandated by regulation. Facilities offered by banks now are often for a maximum of 364 days, which is less than the one year minimum term of a qualifying letter of credit required by Regulation 114.[7] On any new facility, reinsurers are now likely to be required to post collateral with the bank issuing the letter of credit and will have limited options as to eligible collateral.

As with a pledge or trust, a cedent is exposed to the insolvency risk of the bank that issues the letter of credit and would have the additional risk that the obligation of the bank under the letter of credit is an unsecured liability in relation to the cedent. Against that, the reinsurer carries the credit risk of the bank failing, since it remains liable to pay under the reinsurance.[8]

Non-qualifying collateral

Where a U.S. cedent does not require credit for reinsurance, for example because the reinsurer is authorized in the cedent's domiciliary state or following the proposed regulatory modifications which will reduce the collateralization requirements for credit for reinsurance, other types of collateral may be considered, in particular security interests in a bank account and non-regulatory trusts.

Security interests

A reinsurer may secure its reinsurance obligations through the pledge of cash or securities owned by the reinsurer in favour of the cedent. A pledge (called a "charge" in the U.K. and Bermuda) is accomplished through creating a security interest in a bank or securities account of the reinsurer, which it grants in favor of the cedent.

If the pledged account is in the U.S., the parties will enter into an account control agreement with the bank or broker that opens the account. If the charged account is in the U.K. or Bermuda, this is normally addressed through an acknowledgement from the bank. The account control agreement or acknowledgement ensures that the cash or securities held in the pledged or charged account cannot be removed or replaced without the cedent's consent.

Additionally, the parties must negotiate their respective rights to the pledged assets and income earned on those assets, the investment criteria for acceptable securities and discounts applicable in respect of the pledged

assets (referred to as "eligible collateral"). These rights will usually be contained in the reinsurance agreement. The reinsurance agreement or the pledge may contain the circumstances that trigger the right of the cedent to take control of the pledged assets, or for the reinsurer to withdraw some or all of the collateral.

Such negotiations may materially increase the time taken to negotiate the terms of the reinsurance and the frictional costs. It is probable that there will be different forms of agreement between a cedent and each of its reinsurers or a reinsurer and its cedents, since the market has no standard documentation and each agreement must be individually negotiated.

Non-regulatory trusts

Cedents and reinsurers can also negotiate trust arrangements to secure reinsurance obligations with a financial institution serving as trustee. Such a non-regulatory trust can circumscribe cedent withdrawal rights to eliminate the risk of wrongful draw down by a cedent facing bankruptcy.

Trustee fees may be relatively inexpensive and trustees can manage funds and administer distributions from the trust and substitutions of assets. As with pledged accounts, there are costs associated with negotiating the trust arrangements. Unlike a pledge, however, the distribution or release of funds is within the control of the trustee (rather than relying on the consent of the parties in accordance with the terms of the reinsurance contract). Resort to judicial intervention or commencement of enforcement proceedings is unlikely to be necessary in relation to a properly-drafted trust deed.

Bank or trustee insolvency

An advantage to collateralizing reinsurance obligations through the pledge of cash or securities or the deposit of assets in trust is that each approach eliminates reinsurer and cedent credit risk. However, cedents and reinsurers may instead be exposed to risk of the insolvency of the bank or broker that holds the pledged account and of the bank or trust company that acts as a trustee. The instability of the global banking industry and growing government control of major financial institutions suggest that parties should investigate and monitor the condition of banks, brokers or trust companies involved in collateral arrangements.

Structures may be available to mitigate the impact of insolvency of the bank, broker or trustee which holds the collateral. In particular, securities would usually be preferred to cash, since it should be possible to ensure that beneficial ownership remains outside the bankrupt entity's estate. Collateral held in cash will likely be part of the bankrupt entity's estate unless it is held in an account with a third party.

Conclusion

Cedents and reinsurers have a number of options in determining whether to secure or not to secure reinsurance obligations. Other than in the context of collateralization required by regulation, the parties have great flexibility in structuring such arrangements. As and when credit for reinsurance collateralization requirements reduce, so flexibility will increase.

Cedents should consider the financial condition of reinsurers and the cedent's aggregate exposure as an institution to each reinsurer. Reinsurers must weigh the costs of such arrangements and evaluate whether using alternative forms of collateralization at lower cost can enable them to gain a pricing advantage over competitors. Both cedents and reinsurers must take account of the previously unconsidered risk that banks which hold collateral as custodian or trustee or issue letters of credit may themselves fail.

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Endnotes

1. "Proposed Tenth Amendment to Regulation No. 20 (11 NYCRR 125) Credit for Reinsurance from Unauthorized Reinsurers," released by the NYID on December 24, 2008.

2. NAIC press release, December 7, 2008. See "NAIC Adopts Reinsurance Modernization Proposal," December 8, 2008. A revised proposal was released on July 27, 2009.

3. *See* N.Y. Comp. Codes R. & Regs. tit. 11, §§ 126.1 through 126.8.

4. N.Y. Comp. Codes R. & Regs. tit. 11, §126.3(d)(1)-(5).

5. *See* for example *In re Serio (Commercial Risk Re-Insurance Co. v. Superintendent of Insurance of the State of New York)*, 2003 N.Y. App. Div.LEXIS 13320, 2003 WL 22953553, 2003 N.Y. Slip. Op. 19566 (1st Dep't Dec.16, 2003) (No. 2488).

6. See N.Y. Comp. Codes R. & Regs. tit. 11, §§ 79.1 through 79.9.

7. N.Y. Comp. Codes R. & Regs. tit. 11, § 125.4(c)(4)(i); N.Y. Comp.Codes R. & Regs. tit. 11, § 79.2(h).

8. N.Y. Comp. Codes R. & Regs. tit. 11, § 79.5(a).