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# Reinsurance Modernization — A New World View

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Reinsurance is a global business, yet reinsurers suffer from widely disparate accounting and regulatory requirements from jurisdiction to jurisdiction, particularly in the areas of credit for reinsurance and collateral requirements. Recently, insurance regulators in the United States and worldwide have taken dramatic steps toward harmonization, mutual recognition and regulatory cooperation in connection with regulation of reinsurance, with a focus on modernizing collateral requirements.

At its Winter 2008 National Meeting, the National Association of Insurance Commissioners (NAIC) adopted the Reinsurance Regulatory Modernization Framework Proposal (Framework) to modernize state-based regulation of reinsurance, and discussions regarding implementation have continued through the Spring 2009 National Meeting (Spring Meeting). On March 24, 2009, the NAIC's Reinsurance Task Force exposed for comment a draft of federal legislation regarding implementation of the Framework and two drafts relating to the NAIC Credit for Reinsurance Model Act. In the meantime, Congress also has considered various proposals to deregulate or modernize reinsurance regulation.

Given the global economic crisis, opponents of reinsurance reform question whether now is the time to reduce collateral requirements, while proponents firmly believe modernizing (and in some cases reducing) collateral requirements will bring the United States more in line with the worldwide regulation of the rapidly growing global reinsurance market, thereby increasing availability and competition. Because U.S. federal enabling legislation is still needed to implement the new NAIC framework, interested parties will have more opportunities to continue this heated debate.

## NAIC REINSURANCE REGULATORY MODERNIZATION FRAMEWORK

The NAIC adopted the Framework to modernize the current state-based regulation of reinsurance in the United States. This conceptual framework is designed to establish single-state regulation of eligible U.S. and non-U.S. reinsurers, to promote mutual recognition of U.S. and non-U.S. regulatory regimes, and to introduce modified risk-based collateral requirements. The NAIC also ratified several principles for the creation of the Reinsurance Supervision Review Department (RSRD) contemplated by the Framework. The Framework would change the rules for collateralizing reinsurance obligations.

## KEY ELEMENTS OF NAIC FRAMEWORK

The Framework sets forth a new regulatory approach under which eligible reinsurers could be supervised by a single "home state supervisor." Home state supervisors will enter into mutual recognition agreements with non-U.S. jurisdictions, and a reinsurer's collateral requirements will be based on a determination of its risk profile. While the changes will create additional methods for reinsurers to engage in reinsurance business within the United States, reinsurers will have the option to continue under the current regulatory system.

**Creation of two new classes of reinsurers in the U.S.**

- National Reinsurers: A national reinsurer is defined as "a reinsurer that is licensed and domiciled in a home state and approved by such state to transact assumed reinsurance business across the United States while submitting solely to the regulatory authority of the home state supervisor for the purposes of its reinsurance business." National reinsurers will be supervised by their "home state supervisors," whose responsibilities will include (i) approving reinsurers to be licensed as national reinsurers; (ii) examining national reinsurers for solvency and compliance with applicable laws; and (iii) establishing and, when appropriate, adjusting, the collateral ratings of the national reinsurers under their supervision.

- Port of Entry (POE) Reinsurers: A POE reinsurer is "a non-U.S. assuming reinsurer that is certified in a port of entry state and approved by such state to provide creditable reinsurance to the U.S. market." To be certified as a POE reinsurer, a reinsurer must be organized in a non-U.S. jurisdiction that the RSRD has recommended to be eligible for recognition. POE reinsurers will be supervised by "POE supervisors," whose responsibilities will include (i) entering into supervisory recognition frameworks and appropriate regulatory cooperation and information sharing

arrangements with non-U.S. jurisdiction supervisors; (ii) certifying reinsurers as POE reinsurers; (iii) establishing and, when appropriate, adjusting, the collateral rating of the POE reinsurers under their supervision; and (iv) serving as the conduit for, and consulting with, the non-U.S. jurisdiction supervisor concerning any issues regarding the POE reinsurers they supervise. POE reinsurers will be required to submit periodic reports, including audited annual financial statements prepared on a US GAAP basis, if available, to their POE supervisor.

- National insurers and POE insurers will have a minimum capital and surplus requirement of $250 million.

**Establishment of the RSRD.** The supervisory board of the RSRD will consist of state insurance regulators. The RSRD's functions will include:

- Evaluating the supervisory regimes of non-U.S. jurisdictions, as well as considering the rights, benefits and extent of reciprocal recognition afforded by non-U.S. jurisdictions to reinsurers licensed and domiciled in the United States, to determine the recognized jurisdictions from which non-U.S. reinsurers may apply to be certified as POE reinsurers.

- Developing the criteria a state must meet to serve as a home state or POE supervisor. Not all U.S. states are expected to serve as such supervisors because supervisors will need to have extensive resources, expertise and experience with sophisticated market participants.

- Developing a sample supervisory recognition agreement and protocol for recognition and a sample information-sharing and regulatory cooperation agreement between non-U.S. jurisdictions and POE supervisors.

- Providing a purposes and procedures manual for home state and POE supervisors.

**Credit for Reinsurance**. A ceding insurer's jurisdiction of domicile will be required to grant credit for reinsurance ceded to national reinsurers and POE reinsurers, yet will retain its existing authority to determine whether the reinsurance contract transfers risk from the cedent to the reinsurer.

**Collateral Requirements**. A reinsurer's home state or POE supervisor will assign the reinsurer a rating for purposes of determining how much collateral that reinsurer would be required to post for the cedent to obtain credit for reinsurance. The ratings will range from "Secure – 1" for the highest level of financial strength to "Vulnerable – 5" for the lowest.

- The reinsurer must maintain a financial strength rating with at least two ratings agencies approved by the Securities and Exchange Commission (SEC), and the maximum financial strength rating that the home state or POE supervisor may assign a reinsurer will correspond to the lowest financial strength rating from an SEC-approved rating agency as outlined in the table on page 13. Failure to obtain or maintain financial strength ratings from two SEC-approved ratings agencies will result in a Vulnerable—5 rating.

| Rating | M. Best | Standard & Poor's | Moody's Investors Service | Fitch Ratings |
|---|---|---|---|---|
| Secure - 1 | A++ | AAA | Aaa | AAA |
| Secure - 2 | A+ | AA+, AA, AA- | Aa1, Aa2, Aa3 | AA+, AA, AA- |
| Secure - 3 | A, A- | A+, A, A- | A1, A2, A3 | A+, A, A- |
| Secure - 4 | B++, B+ | BBB+, BBB, BBB- | Baa1, Baa2, Baa3 | BBB+, BBB, BBB- |
| Vulnerable - 5 | B, B-, C++, C+, C, C-, D, E, F | BB+, BB, BB-, B+, B, B-, CCC, CC, C, D, R | Ba1, Ba2, Ba3, B1, B2, B3, Caa, Ca, C | BB+, BB, BB-, B+, B, B-, CCC+, CC, CCC-, DD |

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- National reinsurers rated Secure—1 through Secure—3 will not be required to post collateral; Secure—4 reinsurers must post 75 percent collateral; and Vulnerable—5 reinsurers must post 100 percent collateral.

- POE reinsurers rated Secure—1 will not be required to post collateral; Secure—2 reinsurers must post 10 percent collateral; Secure—3 reinsurers must post 20 percent collateral; Secure—4 reinsurers must post 75 percent collateral; and Vulnerable—5 reinsurers must post 100 percent collateral.

- The home state or POE supervisor may adjust a reinsurer's rating downward from the maximum based on certain factors, including the reinsurer's business practices in dealing with its ceding insurers, the reinsurer's reputation for prompt payment of valid claims under reinsurance agreements, and regulatory actions against the reinsurer.

- A reinsurer's participation in any solvent scheme of arrangement or similar procedure that involves one or more U.S. cedents will result in a Vulnerable—5 rating.

The RSRD must undertake a re-examination of the collateral requirements and make recommendations for appropriate collateral amounts for reinsurers within two years after the first full year of operation under these requirements.

**Implementation Issues**

Opponents of the Framework have complained that, in view of the current economic crisis and its causes, now is not the time to decrease collateral requirements. Proponents, however, argue the Framework is necessary and long overdue given the global nature of the industry, and will actually increase options to cedents through a greater number of viable and strong reinsurers. While the debate continues among interested parties, regulators at the Spring Meeting focused on the implementation process.

- On March 24, 2009, the Reinsurance Task Force exposed for comment a draft of federal legislation regarding the implementation of the Framework, referred to as the "Reinsurance Regulatory Modernization Act of 2009." After an abbreviated comment period, the NAIC will submit the draft for consideration by Congress during the current

> **"TREASURY SECRETARY TIMOTHY GEITNER HAS RECENTLY STATED …** THAT THERE IS A NEED FOR FEDERAL REGULATION OF FINANCIAL INSTITUTIONS POSING SYSTEMIC RISK AND NOT CURRENTLY REGULATED BY THE FDIC"

session. This legislation would enact the Framework into federal law. It would authorize the RSRD to oversee the new regulatory regime, under which the RSRD would evaluate supervisory systems of the states and non-U.S. jurisdictions and develop sample reciprocal recognition agreements to be entered into with qualified non-U.S. jurisdictions. The draft legislation would also permit states acting as POE supervisors to enter into those reciprocal recognition agreements under standards recommended by the NAIC and adopted by the RSRD, thereby eliminating constitutional concerns based on the Compact Clause, which prohibits states from entering into "any Agreement ... with another State, or with a foreign Power," without the consent of Congress. To achieve timely and uniform adoption of the Framework by the states, the legislation would preempt all inconsistent state laws. Opponents view the need for such federal legislation as another opportunity to derail the Framework.

- Neither the Framework nor the draft legislation specify the exact organization of the RSRD. To address concerns that states with small ceded premium volume would not be able to play a meaningful role in the RSRD, the NAIC adopted "Principles for the Creation of the RSRD," which were incorporated into the draft legislation. These principles envision the RSRD as a publicly accountable entity that is part of the NAIC with a governing board composed of state insurance regulators, and contain measures to prevent discrimination against small jurisdictions from participating as a home state or POE supervisor.

- At the NAIC Spring Meeting, the Reinsurance Task Force discussed the need to draft model state legislation that will be required for those states that wish to act as home state or POE supervisors and has requested input from regulators and interested parties on the standards that will be required for such supervisors and included in the state legislation.

- The Reinsurance Task Force also adopted a motion to expose for comment a proposed amendment to the Credit for Reinsurance Model Law, which would lower the minimum trusteed surplus requirement applicable to a multiple-beneficiary trust maintained by an assuming insurer in a run-off, and a related guidance memorandum addressing criteria for financial institutions issuing letters of credit and the authority of state Insurance Commissioners to accept alternative collateral arrangements.

## U.S. FEDERAL LEGISLATIVE DEVELOPMENTS

In recent years, Congress has considered several different approaches to insurance reform. While it is not yet clear what legislation will be considered by Congress in 2009, legislation providing for federal regulation of insurance has been proposed and additional legislative proposals are expected. Specifically, legislators recently introduced the National Insurance Consumer Protection Act (NICPA) and have also indicated an intent to reintroduce the Nonadmitted and Reinsurance Reform Act.

- The NICPA envisions an active regulatory role for the federal government as an alternative to the current state-based structure. The NICPA is in part the latest iteration of the National Insurance Act, better known as the optional federal charter bill. It would authorize optional federal chartering or licensing of U.S. and non-U.S. insurers, insurance agencies and insurance producers through a newly created Office of National Insurance within the Treasury. Unlike its predecessors, the NICPA would also provide for the appointment of a separate agency as a systemic risk regulator. This systemic risk regulator's powers would include making a determination that an insurer is so systemically important that it is required to be federally

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regulated. It also adds provisions aimed at consumer protection, including a new National Insurance Guaranty Corporation, and the establishment of a Financial Services Coordinating Council to serve in an advisory capacity to the systemic risk regulator.

- Past versions of the Nonadmitted and Reinsurance Reform Act, on the other hand, would have preserved a state-based approach by permitting a single state to exercise regulatory jurisdiction over credit for reinsurance (the ceding insurer's state) and reinsurers solvency (the reinsurer's state).

Furthermore, Treasury Secretary Timothy Geithner has recently stated in testimony to the House Financial Services Committee that there is a need for federal regulation of financial institutions posing systemic risk and not currently regulated by the Federal Deposit Insurance Company. He has also indicated federal regulation of insurance companies could co-exist with state regulatory authority. Though the details of the reform proposals remain uncertain, in the wake of the current economic crisis, industry commentators consider some form of federal regulation of insurance likely.

## POST PUBLICATION UPDATE

Subsequent to the preparation of this article, several important developments have occurred. In response to significant comments to the March 24, 2009 exposure draft of the Reinsurance Regulatory Modernization Act of 2009, particularly related to concerns about the constitutional authority of the RSRD and a lack of sufficient due process protections, on July 27, 2009, the NAIC circulated a revised exposure draft for comment. Comments to the exposure draft are due on Aug. 17, 2009. It cannot predicted when a draft of the bill will be submitted to Congress for consideration. Further, on June 17, 2009, the Obama administration released a White Paper that outlined sweeping changes to how financial service firms, including certain insurance companies, will be regulated. On July 22, 2009, the administration delivered to Congress proposed legislation that would implement many parts of the White Paper. It is unclear what impact these federal proposals will have on the reinsurance modernization efforts. ■

Please feel free to contact the authors with any question about this article.

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