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UPDATE ON U.S. REINSURANCE COLLATERAL PROPOSALS

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Collateral requirements for reinsurers doing business in the United States have been the subject of a number of proposals in recent months, most notably at the NAIC and in the States of New York and Florida. This paper summarizes the status of these proposals. It will be our aim to update this item periodically to reflect material developments.

The Status Quo

Under the credit for reinsurance laws of the various states, a U.S.-domiciled insurer generally can take credit (as an asset or reduction from liability) for reinsurance ceded to a reinsurer that (1) is licensed to transact insurance or reinsurance, or is accredited as a reinsurer, in the ceding company's state of domicile, or (2) is domiciled in, or has entered as a U.S. branch of an alien insurer through, a state that employs credit for reinsurance standards substantially similar to those of the ceding company's domiciliary jurisdiction. If a U.S.-domiciled insurer cedes to a reinsurer that does not fall into one of these two categories, with certain limited exceptions reinsurance credit is generally allowed only if and to the extent the reinsurer posts collateral as security for its payment obligations under the reinsurance contract. The reinsurer must provide such collateral by way of funds held by or on behalf of the ceding company, including funds held in trust for the ceding company's benefit. The collateral must be in the form of cash, securities listed by the Securities Valuation Office of the NAIC and qualifying as admitted assets, or clean, irrevocable, unconditional letters of credit.

The NAIC's Reinsurance Regulatory Modernization Framework Proposal

The NAIC's Reinsurance Regulatory Modernization Framework proposal aims to eliminate the dichotomy between U.S. and non-U.S. reinsurers as the controlling factor in

determining collateral requirements. Key elements of the current NAIC framework proposal include:

- Establishment in the NAIC of a **Reinsurance Supervision Review Department ("RSRD")**.

- Two new classes of reinsurers in the United States: **national reinsurers** and **port of entry ("POE") reinsurers**, each of which would be **regulated by a single U.S. supervising jurisdiction**. A **minimum capital and surplus requirement of $250 million** would apply to national reinsurers and POE reinsurers.

- A **national reinsurer** is defined as "a reinsurer that is licensed and domiciled in a [U.S.] 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 purposes of its reinsurance business."

- A **POE reinsurer** is defined as "a non-U.S. assuming reinsurer that is certified in a [U.S.] port of entry state and approved by such state to provide creditable reinsurance to the U.S. market. Certification by a port of entry state does not provide independent authority to transact the business of insurance in the United States." To be certified as a POE reinsurer, the company must be organized and licensed in **a non-U.S. jurisdiction that the RSRD has recommended as eligible for recognition**. A POE reinsurer would be required to file certain **periodic reports** with the supervisory agency of its port of entry state.

- The **RSRD's various functions** would include **determination of jurisdictions eligible to be recognized as POE states**. A **supervisory board of the RSRD** (consisting of state insurance regulators) would, among other things, establish uniform standards for supervising jurisdictions of national and POE reinsurers and determine collateral reduction eligibility criteria.

- With regard to **credit for reinsurance**:
  - A ceding company's domiciliary jurisdiction would be **required to grant credit** for reinsurance ceded to national reinsurers and POE reinsurers.
  - **Risk transfer** determinations would remain within the authority of the ceding company's domiciliary regulator.
  - **The supervising jurisdiction for a national reinsurer or a POE reinsurer would assign the reinsurer one of five ratings: Secure-1, Secure-2, Secure-3, Secure-4, Vulnerable-5**. The rating would be **based on the reinsurer's financial strength ratings** (from S&P, Moody's, Fitch, A.M. Best, or other rating agency approved by the U.S. Securities and Exchange Commission), as well as **additional factors** that could result in a lower reinsurance rating being assigned by the supervising jurisdiction (e.g., the reinsurer's claims payment track record). A reinsurer's failure to maintain at least two financial strength ratings from SEC- approved rating agencies would result in a Vulnerable-5 rating.
  - The supervising jurisdiction would be required to use the lowest financial strength rating from an SEC-approved rating agency in establishing the maximum rating for the reinsurer, **in accordance with the following scale**.

Rating	Best	S&P	Moody's	Fitch
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

- The rating assigned by the reinsurer's supervising jurisdiction would determine the amount of reinsurance collateral required on a sliding scale, as follows:

  Secure-1 – 0% collateral required

  Secure-2 – 10% collateral required

  Secure-3 – 20% collateral required

  Secure-4 – 75% collateral required

  Vulnerable -5 – 100% collateral required

- All reinsurers, both U.S.-licensed and non-U.S., would have the option to continue to operate under the regulatory framework now in place. Thus, the proposal contemplates **four methods of conducting reinsurance business in the United States** – (1) as a national reinsurer, (2) as a POE reinsurer, (3) as an assuming reinsurer that is licensed, accredited, or otherwise meets the requirements of Section 2 of the current NAIC Model Credit for Reinsurance Law, and (4) as an assuming reinsurer (regardless of state or country of domicile) that does not meet the requirements of Section 2 of the current NAIC Model Law by posting the required collateral.

- Requirements for certain mandatory provisions in the **reinsurance contracts**. The Task Force intends to submit a referral to the NAIC Statutory Accounting Principles Working Group recommending review of SSAP No. 62 – Property and Casualty Reinsurance, and consideration of contract clause requirements.

- **Implementation** of the proposal would apply to reinsurance contracts entered into or renewed after the effective date of the proposal, with an appropriate implementation period to be developed.

- The Reinsurance Task Force recommends **federal enabling legislation** to provide, among other things, for the creation of the RSRD, which would establish the requirements for home state and POE supervisors' regulation of national and POE reinsurers.

- The Reinsurance Task Force will address **life reinsurance issues** – including comprehensive life reinsurance regulatory reform, risk transfer requirements, and disparity in solvency standards and reserve requirements for U.S. and non-U.S. life insurance companies – upon completion of this proposal.

STATUS: The NAIC's Reinsurance (E) Task Force has issued an exposure draft of the current Reinsurance Regulatory Modernization Framework proposal, dated August 20, 2008. It is available at http://www.naic.org/committees_e_reinsurance.htm. The comment period on the exposed draft ends September 5, 2008.

New York

New York has proposed modifications to its credit for reinsurance regulations with the aim of attracting more reinsurance capital to the New York market. Like the NAIC proposal, New York's proposal essentially treats non-U.S. reinsurers that maintain the highest agency ratings like reinsurers that are licensed or accredited in New York.

Key elements of the most recent New York proposal as it relates to credit for reinsurance include:

- Adds provision allowing a ceding insurer to take credit for reinsurance recoverable from any assuming reinsurer that is not authorized or accredited in New York if that reinsurer maintains a **stand-alone financial strength rating from at least two of certain enumerated rating agencies** (S&P, Moody's, Fitch, A.M. Best, or other rating agency recognized by the NAIC's Securities Valuation Office).

- In addition to the credit rating requirement, the ceding insurer must maintain satisfactory evidence that the unauthorized or unaccredited reinsurer (i) meets the **standards of solvency**, including standards for capital adequacy, established by its domestic regulator; (ii) is **authorized in its domiciliary jurisdiction** to assume the kind(s) of reinsurance ceded by the ceding insurer; and (iii) maintains **policyholders' surplus or equivalent in excess of $250,000,000**. The ceding insurer also must maintain certain audited financial statements of the reinsurer prepared under, or reconciled to, U.S. GAAP or U.S. SAP.

- If the reinsurer is a non-U.S. company, the reinsurer's domiciliary regulator must have a **memorandum of understanding with the New York Insurance Department**, and the reinsurer's domiciliary jurisdiction must allow U.S. reinsurers **access to such jurisdiction's market** on comparably favorable terms.

- The **amount of credit allowed would be determined on a sliding scale, based on the reinsurer's agency ratings**. New York's scale is essentially equivalent to that under the NAIC proposal; if a ceding company seeks 100% credit in New York, the reinsurer would have to post the same amount of collateral as called for under the NAIC proposal under the same agency ratings circumstances.

- Requirements for certain mandatory provisions in the reinsurance contracts.

- The New York Insurance Superintendent retains the right, in his/her discretion, to disallow all or a portion of the credit based on, among other things, the ceding company's reinsurance program, the financial condition of the unauthorized reinsurer, and the reinsurer's claim payment history.

- The proposal would apply to reinsurance contracts entered into or renewed on or after January 1, 2009.

STATUS: Pending.

Florida

In a move by another state for which reinsurance capacity, especially in the property insurance market, is a paramount concern, Florida has proposed a rule for the allowance of credit for reinsurance without full collateral for transactions involving reinsurers that are not authorized or accredited in Florida. The proposed rule applies only to property and casualty insurance; it does not apply to life and health insurance.

Key elements of the Florida proposal as it relates to credit for reinsurance include:

- Creates the category of **eligible reinsurers**, which includes unauthorized and unaccredited reinsurers that the Commissioner determines by order (upon application by the reinsurer) to have met the regulation's requirements for eligible reinsurers. To become an **eligible reinsurer**, a company must, at a minimum, (i) hold **surplus in excess of $100 million**; (ii) be **authorized in its domiciliary jurisdiction** to assume the kind(s) of reinsurance ceded by the ceding insurer; and (iii) be domiciled in an **eligible jurisdiction.**

- The Florida Insurance **Commissioner would determine whether a jurisdiction qualifies as an eligible jurisdiction**. Factors in this determination include, among others, the agreement of the insurance regulatory body of the jurisdiction in question to provide information, the jurisdiction's regulatory regime, history of performance by reinsurers in the jurisdiction, and access to the jurisdiction's markets by U.S. reinsurers on comparably favorable terms. The regulation also authorizes the Commissioner to rely on NAIC findings when making a determination as to an eligible jurisdiction.

- A ceding company cannot take credit for reinsurance with an eligible reinsurer under the provisions of the new regulation unless the eligible reinsurer maintains on a **stand-alone** basis **financial strength ratings** from at least two rating agencies (from among S&P, Moody's, Fitch, A.M. Best) and the ceding insurer maintains satisfactory evidence that the eligible reinsurer meets the **standards of solvency**, including standards for capital adequacy, established by its domestic regulator.

- The collateral required to allow 100% credit for the reinsurance ceded to the eligible reinsurer is determined on a sliding scale, based on the eligible reinsurer's agency ratings, identical to that set forth in the NAIC proposal.

- Requirements for certain mandatory provisions in the reinsurance contracts.

- The Commissioner retains the right to disallow all or a portion of the credit based on, among other things, the ceding company's reinsurance program, the financial condition of the reinsurer, and the reinsurer's claim payment history when such action is in the best interests of market stability and the solvency of the ceding insurer.

STATUS: The final public hearing on the adoption of the proposed amendments to Rule 69O-144.007 is scheduled for September 16, 2008.

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