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UPDATE ON NAIC 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 developments in recent months, most notably the NAIC's Reinsurance Regulatory Modernization Framework Proposal. This paper summarizes the status of the NAIC's Framework Proposal, as well as other recent actions by the NAIC on the reinsurance collateral front. Most recent developments are set out in red text.

The Status Quo

Under the current 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, reinsurance credit is allowed only (with certain limited exceptions) 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 establish single-state regulation for reinsurers and to eliminate the dichotomy between U.S. and non-U.S. reinsurers as the controlling factor in determining collateral requirements. Key elements of the NAIC framework proposal include:

- Establishment in the NAIC of a **Reinsurance Supervision Review Department ("RSRD")**. Proposed federal legislation exposed by the NAIC's Reinsurance Task Force now refers to a **Reinsurance Supervision Review *Board* (see below).**

- 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 the U.S. 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 and verification that agreements are properly accounted for and reported by ceding companies would remain within the authority of the ceding company's domiciliary regulator.

- **The U.S. 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

- Subject to a **significant exception for national reinsurers** rated Secure-3 or above, the rating assigned by the reinsurer's U.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

In recognition of the regulatory requirements to which national reinsurers are subject (including, for example, capital maintenance requirements under U.S. licensing standards and U.S. Risk Based Capital requirements), **a national reinsurer rated Secure-3 or above would not be required to post collateral**.

- Within two years after the first full year of operation under the new collateral requirements, the **RSRD would be required to reexamine collateral requirements** and make recommendations with respect to appropriate collateral amounts for national and POE reinsurers.

- 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 Reinsurance Task Force has stated that it 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.

- **Except for life reinsurance contracts, implementation** of the proposal would apply to reinsurance contracts entered into or renewed after the effective date of the proposal (i.e., the effective date of federal enabling legislation referred to below), with an appropriate implementation period to be developed. The proposal would apply to **life reinsurance**

contracts upon the earlier of (i) 24 months from the effective date of the proposal, and (ii) the implementation of U.S. principles-based reserving standards for life insurance.

- The Reinsurance Task Force will continue to address **other life reinsurance issues** following completion of this proposal.

- The Reinsurance Task Force has exposed for comment proposed **federal legislation** to provide for implementation of the framework, including the creation of, and granting of appropriate authority to, a Reinsurance Supervision Review Board. (The Task Force previously stated that it believed that a federal approach would eliminate legal concerns and facilitate inclusion of the mutual recognition and reciprocity concepts.) The comment period on the proposed bill – titled the ***"Reinsurance Regulatory Modernization Act of 2009"*** – ends on April 23, 2009. The text of the bill is available at http://www.naic.org/documents/committees_e_reinsurance_fed_legislation_draft.pdf.

GENERAL STATUS: On September 22, 2008, the NAIC's Reinsurance (E) Task Force adopted the most recent exposure draft of the Reinsurance Regulatory Modernization Framework proposal, dated September 12, 2008, and referred it to the Financial Condition (E) Committee with the recommendation that the E Committee adopt it. On September 24, 2008, the Financial Condition (E) Committee adopted the proposal as set forth in the September 12, 2008, exposure draft. On December 7, 2008, the NAIC's Executive Committee and Plenary adopted the proposal and approved a motion to create a Reinsurance Supervision Review Department. The Reinsurance Task Force exposed a March 24, 2009, draft of proposed federal legislation titled the "Reinsurance Regulatory Modernization Act of 2009." The comment period for the proposed bill expires on April 23, 2009.

Proposed Amendment To Credit For Reinsurance Model Law

Responding to concerns that assuming insurers in run-off are unduly burdened by the current $20 million minimum trusteed surplus requirement for multiple-beneficiary trusts, the Reinsurance Task Force has exposed a proposed amendment to Section 2(D)(3) of the Credit for Reinsurance Model Law. The proposed amendment authorizes the commissioner with principal regulatory oversight of the trust, after an appropriate risk assessment, to allow exceptions to the $20 million trusteed surplus requirements for assuming insurers who have permanently discontinued underwriting new business secured by the trust for at least three years. In no event, however, would the trusteed surplus be allowed to fall below 50% of the assuming insurer's liabilities attributable to reinsurance ceded by U.S. ceding insurers. The text of the proposed amendment – which is open for comment until April 23, 2009 – is available at: **http://www.naic.org/documents/committees_e_reinsurance_mutli_beneficiary_trust_proposal.pdf**.

Guidance Memorandum On Reinsurance Collateral Requirements

In light of the recent upheaval in the financial markets, the Reinsurance Task Force has exposed a guidance memorandum on the application of the authority granted to commissioners under the Credit for Reinsurance Model Law and Credit for Reinsurance Model Regulation to accept "any other form of security acceptable to the commissioner," and to determine that a financial institution meets the criteria for a "qualified U.S. financial institution." Among other things, the guidance memorandum cautions commissioners to exercise their authority concerning other forms of security "on a case-by-case basis only after careful and thorough evaluation of all information relevant to each situation." In addition, the guidance underscores that the permitted security should be held in the United States for the sole benefit of the ceding insurer and subject to the exclusive control of the ceding insurer or, in the case of a trust, in a qualified U.S. financial institution. The Task Force has stated that it will consider the development of a communication mechanism among NAIC members relating to situations where "other forms" of security have been accepted.

The guidance memorandum is open for comment until April 23, 2009, and is available at: **http://www.naic.org/documents/committees_e_reinsurance_collateral_guidance_memo.pdf**.

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