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UPDATE ON U.S. REINSURANCE COLLATERAL PROPOSALS

By Anthony Cicchetti

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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. Most recent developments are set out in red text.

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, 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")**.

- 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 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.

- **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 recommends **federal enabling legislation** to provide, among other things, for the granting of appropriate authority to the RSRD, which would establish the requirements for home state and POE supervisors' regulation of national and POE reinsurers. The Task Force believes that a federal approach would eliminate legal concerns and facilitate inclusion of the mutual recognition and reciprocity concepts into the framework.

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 September 12, 2008, version of the Framework proposal is available at http://www.naic.org/committees_e_reinsurance.htm.

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. Given the NAIC's adoption of the Framework proposal, however, New York stated at the December 7 NAIC meeting that it will withdraw the pending proposal (described below) relating to its corresponding regulation (Reg. 20) with the intent of making its regulation uniform with the Framework.

Key elements of the New York proposal as it relates to credit for reinsurance had included:

- 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: Upon adoption of the NAIC Framework proposal, New York stated that it will withdraw this proposal.

Florida

In a move by another state for which reinsurance capacity, especially in the property insurance market, is a paramount concern, the Florida Office of Insurance Regulation recently announced that the Florida Cabinet, in its capacity as the Financial Services Commission, has approved 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 rule applies only to property and casualty insurance; it does not apply to life and health insurance.

Key elements of the Florida rule as it relates to credit for reinsurance include the following. However, given the NAIC's adoption of the Framework proposal, Florida stated at the December 7 NAIC meeting that it will conform its requirements to be consistent with the NAIC Framework, so modifications can be expected.

- 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 determines 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 rule 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 rule 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: On September 16, 2008, the Florida Office of Insurance Regulation announced that the Florida Cabinet, in its capacity as the Financial Services Commission, approved the proposed rule. Upon adoption of the NAIC Framework proposal, Florida stated that it will conform its requirements to be consistent with the Framework.

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