NAIC Reinsurance Supervision Review Department

Draft Proposal to Grant Recognition of Regulatory Equivalence to Non-U.S. Insurance Supervisors

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I EXECUTIVE SUMMARY

In light of a number of changes in the insurance and reinsurance marketplace, there is an interest by regulators in re-evaluating the regulatory framework for reinsurance. Some of the market changes instigating a need for this shift are:

- Globalization - as noted in the NAIC US Reinsurance Collateral White Paper, "Reinsurance Market Analysis" section, "The [Standard and Poor's Global Reinsurance Highlights Report] 2005 edition identifies the top 40 global reinsurance groups as measured by net reinsurance premiums written. While this report underscores the international nature of the reinsurance market, it also illustrates the small number of wholly owned U.S. reinsurance corporations. Since 33 of the top 40 reinsurance groups are domiciled outside the U.S., it makes sense that a large market share is held by non-U.S. reinsurers (directly or ultimately controlled through offshore parent corporations). "

- Increased cross-border reinsurance: The NAIC US Reinsurance Collateral White Paper "Reinsurance Market Analysis" section notes that, "unaffiliated premiums [i.e., ceded to unaffiliated reinsurers] have increased at an average annual rate of 8.2% (on a compounded basis) over the last 5 years while the affiliated premiums have increased at a 26.5% rate over that same time period primarily due to the increase of affiliated business being ceded to parent companies in Bermuda and Europe." This trend suggests that the most efficient regulatory structure would involve harmonization among regulatory systems equipped to address cross-border reinsurance transactions.

- Significant advancement toward the development of international accounting standards that should result in increased transparency.

- Concrete steps toward regional regulatory harmonization – e.g., EU Reinsurance Directive.

A number of state insurance regulators have acknowledged that in light of the evolving international marketplace, it is appropriate at this time to consider the question of whether a different type of regulatory framework for reinsurance in the U.S. is warranted. The regulators believe that a reinsurance regulatory framework must be sufficiently flexible to accommodate the rapidly changing reinsurance environment while providing for appropriate levels of financial stability, solvency and predictability that are critical to a vigorous market and a strong and secure insurance regulatory system.

Regulators hope to facilitate cross-border transactions and enhance competition within the U.S. market while ensuring that U.S. insurers and policyholders are adequately protected from a solvency perspective.

1. During the Joint Meeting of the Executive Committee/Plenary on Sunday, March 5, 2006, the following charge to the Reinsurance Task Force was adopted:

   > "The Reinsurance (E) Task Force is directed to develop alternatives to the current reinsurance regulatory framework, including the use of collateral within the U.S. and abroad. Consider approaches that account for a reinsurer's financial strength regardless of domicile, i.e., state or country. Identify and consider variations in state law and regulation relative to reinsurance contracts, financial reporting, etc. As part of its deliberations, the Task Force should consult with international regulators in addition to all other interested parties. The Task Force shall present the proposal to the membership by the December 2006 national meeting."

2. As part of amending the reinsurance regulatory framework, U.S. insurance regulators are proposing to develop a system that would allow for a single state regulator for authorized reinsurers (passport system). It incorporates the concept of "single state" regulation. This provides for a single point for establishment of laws and regulations governing reinsurance transactions and retains the expertise of state regulators.

3. U.S. licensed insurers providing reinsurance would have a choice as to which state would act as their home state regulator. As long as the U.S.-licensed reinsurer complies with applicable laws and regulations of its home state, it can automatically assume reinsurance business in all other states (host states). Cross-border business of reinsurers domiciled in jurisdictions outside the U.S. and not licensed in any accredited state would be facilitated by mutual recognition agreements negotiated by the NAIC Reinsurance Supervision Review Department (RSRD).

4. This would include a mechanism for certification of non-U.S. reinsurers by a port of entry state. The RSRD would establish principles concerning regulatory equivalence as well as new minimum guidelines that states would have to follow in order to be a port of entry for a reinsurer licensed by a reciprocal non-U.S. regulatory entity.

5. This reinsurance regulatory modernization proposal would also require the establishment of a mutual recognition framework. The framework will allow both host and home supervisors to recognize the quality of regulation and supervision in the other's jurisdiction and consequentially to remove or greatly mitigate additional regulatory/supervisory burdens to reinsurers in those same jurisdictions. There are a number of different approaches that could be adopted in order to achieve mutual recognition, as discussed more fully in Part II. Issues that need to be taken into account include the evaluation process and the nature of the reciprocal recognition that would be required.

6. Under this proposal, as an alternative to becoming licensed as an insurer in the U.S. to qualify as an admitted or authorized insurer or posting 100% collateral, a non-U.S. reinsurer could qualify for credit for reinsurance in the United States by becoming "certified" as a reinsurer by a certified home state serving as the reinsurer's United States port of entry.

   - A state will be required to grant appropriate credit for reinsurance ceded by one of its licensed insurers to a reinsurer licensed or certified in a certified home state and in compliance with the requirements of the reinsurer's U.S. domiciliary or port-of-entry regulator.
   - "Appropriate" means that the ceding insurer's domiciliary regulator retains the same authority it has under existing law to evaluate the amount of the liabilities ceded and retained, to determine whether the contract qualifies as reinsurance, and to evaluate the transaction's compliance with diversification requirements, material transaction laws, hazardous financial condition laws, etc.
   - In order to be certified as a reinsurer, a company must be domiciled and licensed under a functionally equivalent jurisdiction recognized by the RSRD.
   - The level of collateral a certified reinsurer must post will be determined by its U.S. port-of-entry regulator based on the reinsurer's claims-paying ability (considering financial condition and any other relevant factors) in accordance with uniform standards established by the NAIC.
   - The port of entry jurisdiction will be the primary U.S. regulator of a certified reinsurer. Allocation of authority over the reinsurer's U.S. activities between the port of entry and non-U.S. domiciliary regulators will be determined in accordance with the principles discussed below. We should consider the possibility that it might vary from country to country in accordance with the terms of the applicable mutual recognition agreements.
   - Provisions should be considered for shared supervision of affiliated reinsurance groups and the designation of a lead regulator or regulators.
   - In order to be a port of entry for non-U.S. reinsurers, a state should certify a reinsurer and set its required collateral level in accordance with NAIC standards. However, the U.S. ceding insurer's host state Commissioner would have discretion to amend the collateral requirements of certified non-U.S. reinsurers.
   - In order to receive and maintain accreditation, a state must also meet NAIC standards with regard to conducting adequate supervision of its licensed and, where applicable, its certified reinsurers.

7. A cornerstone of this proposal is the establishment of a process for recognizing the regulatory equivalence of other jurisdictions, so that reinsurers from those jurisdictions can apply to obtain certification in the United States and may qualify for a reduction in their collateral requirements. The reduction in collateral requirements is based on the rating received. The framework for determining functional equivalence must take into account whether and to what extent the "host regulator" should rely or "recognize" the prudential supervision of the "home

regulator", and whether and to what extent the "host regulator" should supplement "home regulation" with additional "host rules" in order to maintain its "appropriate level of protection."

8. Supervisors should start by asking the question: On what common basis can legal, regulatory and political systems interact without merging into one? In other words, how do they decide what legitimate differences between them can be accepted? In order to give effect to this general principle, supervisors adopt mutual recognition as a contractual norm whereby they agree to "swap" jurisdictional authority among themselves.

II PRINCIPLES FOR REGULATORY EQUIVALENCE

These principles, based on work done by the International Association of Insurance Supervisors (IAIS), should be considered as a starting point for developing a framework for mutual recognition.

Principle 1

The RSRD recognizes functionally equivalent reciprocal non-U.S. regulatory regimes.

What does "recognizes" mean?

U.S. insurance regulators, through the RSRD, recognize a non-U.S. certified regulatory regime when the RSRD declares that the non-U.S. regulatory regime meets explicit criteria for such recognition.

What does "functionally equivalent" mean?

Equivalence should be defined according to both the process and outcomes achieved by the regulatory regime. It requires a comparison of the regulatory framework as well as outcomes of the U.S. regulatory framework and the relevant non-U.S. regulatory regime. The equivalence test does not require that the U.S. and non-U.S. regulatory regimes impose comparable regulatory burdens on regulated entities.

The equivalence test is flexible. What degree of equivalence is "sufficient" for "functional equivalence" will depend on a number of factors. For example, if we decide that the effect of recognition is to give a non-U.S. reinsurer only limited relief from the U.S. regulatory regime, it may not be necessary for the home regulatory regime to achieve all the relevant processes and outcomes of the U.S. regulatory regime. Likewise, the degree of equivalence that is sufficient may be affected by the conditions imposed on any relief from the U.S. regulatory regime granted to a non-U.S. reinsurer.

Is reciprocal recognition a relevant factor?

The basis of Principle 1 is that recognition of a non-U.S. regulatory regime is largely dependent on the nature of the non-U.S. regulatory regime and, in particular, its equivalence to the U.S. regulatory framework. This equivalence ought to qualify the U.S. regulatory regime for reciprocal recognition by the non-U.S. jurisdiction. If not, then recognition should not be granted by the RSRD when the effect would be competition on unequal terms in the international reinsurance market.

Why has this principle been proposed?

Recognition of a non-U.S. regulatory regime will only be granted if an adequate assessment of the quality of a non-U.S. regulatory regime has been made before recognizing it. Principle 1 defines equivalence according to the processes and outcomes of the regulatory regime because it is both the processes and outcomes of the regulatory regime that affect solvency and policyholder protection. Many different regulatory mechanisms may achieve the desired solvency and policyholder protection outcomes. However, defining equivalence according to specific regulatory mechanisms may not take into account whether those regulatory mechanisms are effectively implemented. An outcome-focused test would involve assessment of the effectiveness of the non-U.S. regulatory regime.

The regulatory equivalence test in Principle 1 is flexible because the regulatory mechanisms and the outcomes of the U.S. regulatory regime and relevant non-U.S. regulatory regimes may not be identical and different situations may result in varying degrees of equivalence.

U.S. regulators will continue to monitor developments at the IAIS concerning mutual recognition. These proposed agreements are also generally expressed in terms of outcomes (rather than regulatory mechanisms). In a number of non-U.S. jurisdictions, recognition of other regulatory regimes and access of reinsurers from other countries is already conditional on the equivalence of the relevant regulatory regimes.

Principle 2

U.S. regulators, via the RSRD, give the fullest possible recognition to functionally equivalent reciprocal non-U.S. regulatory regimes.

What does the principle mean?

When regulating non-U.S. reinsurers, U.S. insurance regulators will rely on their home jurisdiction's regulation to the greatest extent possible.

In general, this principle means that U.S. insurance regulators will only supplement the non-U.S. regulatory regime by requiring the non-U.S. reinsurer to comply with U.S. laws that are necessary to ensure the achievement of the fundamental purposes of U.S. regulation.

Why has this principle been proposed?

This principle enables U.S. insurance regulators to balance the competing goals of, on the one hand, facilitating the availability of non-U.S. reinsurance cover, and, on the other hand, protecting U.S. ceding insurers and policyholders.

Principle 3

U.S. insurance regulators must have effective cooperation arrangements with the home regulators of non-U.S. reinsurers.

What does this principle mean?

Effective cooperation arrangements may be bilateral or multilateral. They will generally be in the form of a Memorandum of Understanding (MOU), Mutual Recognition Agreement (MRA), or some other documented arrangement. They may, however, be supplemented by more informal arrangements and relationships. Unilateral recognition, although it is by definition not "mutual," can also be an option if a host supervisor unilaterally chooses to place reliance on the work of another. This could lead to subsequent negotiations towards a genuine "mutual" recognition if the parties wish to do so.

Effective cooperation arrangements encompass:

(a) sharing of information about reinsurers domiciled in the various participating jurisdictions; and
(b) cooperation in relation to:
    (i) the supervision and investigation of non-U.S. reinsurers; and
    (ii) enforcement actions involving non-U.S. reinsurers.

In particular, effective cooperation arrangements ensure that the home regulator will, if requested by U.S. insurance regulators, take appropriate actions to protect U.S. ceding insurers and policyholders. Those actions should be at least as effective as actions the home regulator would take to protect insurers and policyholders in its own jurisdiction.

In general, effective co-operation arrangements will not be possible unless the home regulator has power under the home regulatory regime to cooperate with U.S. insurance regulators, through the RSRD, in the ways discussed above.

Why has this principle been proposed?

In order for a jurisdiction to be effective in providing equivalent regulatory outcomes, U.S. insurance regulators need to be able to:

(a) access information that is only available from the home regulator; and
(b) ask the home regulator to:

(i) supervise or investigate activities conducted in the home jurisdiction; and
(ii) take enforcement action in the home jurisdiction.

U.S. insurance regulators may have no ability to conduct necessary examinations or investigations outside the U.S. without assistance from the home regulator. Moreover, under Principle 2, non-U.S. facilities, services and products will largely be regulated by the laws of their home jurisdiction. Generally, U.S. insurance regulators cannot enforce the laws of the home jurisdiction or bring enforcement action as regulator in the home jurisdiction. Therefore, it is important that co-operation arrangements enable us to ask the home regulator to supervise or investigate non-U.S. reinsurers, and to commence enforcement action against reinsurers that are violating their obligations.

Principle 4

U.S. insurance regulators must be able to enforce the U.S. laws that apply to non-U.S. reinsurers as stipulated in reinsurance agreements.

What does the principle mean?

U.S. insurance regulators must be able to bring judicial and administrative enforcement action in the U.S. against non-U.S. reinsurers for breaches of the U.S. law provisions that apply to non-U.S. reinsurers by the terms of either the reinsurance contract or the applicable mutual recognition agreement. In order to do this, U.S. insurance regulators must have both sufficient information and legal power to commence enforcement action.

To ensure that U.S. insurance regulators have sufficient information and legal power, U.S. insurance regulators may:

(a) impose appropriate conditions on a license; or
(b) impose appropriate conditions on any relief from the U.S. regulatory regime granted to a non-U.S. reinsurer.

Appropriate conditions may include requiring the non-U.S. reinsurer to:

(a) enter into co-operation arrangements with us that will enable U.S. insurance regulators to obtain information from the non-U.S. reinsurer;
(b) submit to the exclusive jurisdiction of the U.S. courts;
(c) appoint an agent in the U.S. to accept service of process on behalf of the non-U.S. reinsurer; and
(d) comply with any lawful direction of U.S. insurance regulators or a U.S. court.

Why have we adopted this principle?

U.S. insurance regulators may rely on the home regulator to bring some enforcement action against a non-U.S. reinsurer in its home jurisdiction. However, U.S. insurance regulators must be able to enforce in the U.S. those U.S. laws that apply to the non-U.S. reinsurer because:

(a) the U.S. laws that apply to the non-U.S. reinsurer will be those that we consider are essential to protecting U.S. solvency regulation and policyholder protection; and
(b) the non-U.S. reinsurer's home regulator may not be able to enforce these U.S. laws in its home jurisdiction.

The RSRD shall consider any documented evidence of substantial problems with the enforcement of valid United States judgments in the domiciliary jurisdiction of the applicant, or of the refusal of applicant to abide by judgments against it rendered by a U.S. court on the ground that the court lacks jurisdiction over the applicant. Two years after ratification by the United States of the Hague Choice of Courts Convention, the RSRD shall require that the applicant agree to be bound by that Convention.

Principle 5

Adequate rights and remedies must be practically available to U.S. insurers/policyholders that access non-U.S. reinsurance capacity in the U.S.

What does the principle mean?

The phrase "rights and remedies" includes:

(a) the right to seek remedies through private judicial actions;
(b) access to internal and external alternative dispute resolution; and
(c) access to compensation arrangements.

What does "practically available" mean?

A right or remedy may not be practically available to U.S. insurers if it can only be pursued through private action in a non-U.S. jurisdiction. High costs, the problems associated with briefing non-U.S. lawyers, and other practical matters are likely to be a significant impediment to any attempt by a U.S. insurer to obtain remedies through private judicial action in a non-U.S. jurisdiction.

Why has this principle been proposed?

U.S. insurance regulators have proposed this principle because adequate rights and remedies are essential to the protection of U.S. insurers and policyholders.

Principle 6

Adequate disclosure must be made of information that U.S. regulators may reasonably require in order to make an informed assessment of the consequences of any significant differences between the regulation of the non-U.S. reinsurers and the regulation of comparable U.S. reinsurers

What does the principle mean?

Non-U.S. reinsurers will generally need to disclose the following information in an appropriate manner:

(a) that the non-U.S. reinsurer is regulated, at least in part, by the laws of a non-U.S. jurisdiction, and those laws differ from U.S. laws;
(b) that the rights and remedies available to U.S. insurers who access the non-U.S. reinsurer may differ from those of U.S. insurers who access comparable U.S. reinsurers;
(c) the nature of the rights and remedies available to U.S. insurers under the non-U.S. regulatory regime and how those rights and remedies can be accessed;
(d) the nature of any special risks associated with the non-U.S. reinsurers, such as risks arising from taxation, non-U.S. currency or time differences; and
(e) the nature and consequences of significant differences in the regulatory regime, such as the use of accounting standards that differ from those used in the U.S.

Why has this principle been proposed?

Disclosure fulfills an important role in the U.S. regulatory regime. A key purpose of disclosure requirements is to ensure that ceding insurers and policyholders have access to sufficient information to make confident and informed decisions and by ensuring that those disclosures are made in an appropriate form.

The effect of the Principles, and in particular Principles 1 and 2, is that, from the point of view of U.S. insurers, the outcomes of the regulation of non-U.S. reinsurers will be equivalent to the outcomes of the regulation applying to comparable U.S. reinsurers. In particular, the combination of the non-U.S. regulatory regime and those parts of the U.S. regulatory regime that apply to the non-U.S. reinsurer will ensure that U.S. insurers and policyholders receive all the information necessary to make informed and confident decisions about the relevant non-U.S. reinsurer.

U.S. insurance regulators believe that some additional disclosures will be required even though the outcomes of the regulation of non-U.S. reinsurers are deemed equivalent to the outcomes of the regulation applying to comparable U.S. insurers. The competent authorities responsible for the supervision of regulated entities in a reinsurance group and the competent authority appointed as the coordinator for that reinsurance group shall cooperate closely with each other.

Without prejudice to their respective responsibilities, the competent authorities concerned shall consult each other with regard to the following items, where these decisions are of importance for other competent authorities' supervisory tasks:

(a) changes in the shareholder, organizational or management structure of regulated entities in a financial conglomerate, which require the approval or authorization of competent authorities;
(b) major sanctions or exceptional measures taken by competent authorities.

A competent authority may decide not to consult in cases of urgency or where such consultation may jeopardize the effectiveness of the decisions. In this case, the competent authority shall immediately inform the other competent authorities.

Principle 7

An equivalent regulatory regime is clear, transparent and certain

What does the principle mean?

A "clear" regulatory regime is one that is clearly articulated and easily understood. A "transparent" regulatory regime is one whose rules, policies and practices are readily available to and known by all relevant persons. A "certain" regulatory regime is one that is consistently applied and not subject to indiscriminate change. At a minimum, this principle means that the relevant parts of the regulatory regime must be in written form, available in English, and not subject to arbitrary discretion.

Why has this principle been proposed?

U.S. insurance regulators will not regard a regulatory regime that fails to meet these minimum conditions as equivalent to the U.S. regulatory regime because:

(a) it cannot be consistently or reliably applied or enforced; and/or
(b) U.S. insurance regulators might not be able to obtain sufficient knowledge of how the regime works in practice to assess the regime.

Principle 8

An equivalent regulatory regime is adequately enforced in the home jurisdiction

What does the principle mean?

A regulatory regime is adequately enforced if the regulator (or other responsible body):

(a) has sufficient powers of investigation and enforcement;
(b) has sufficient resources to use those powers; and

(c) uses those powers and resources to promote compliance with the regulatory regime.

Additionally, the legal system within which the regulatory regime operates should be independent and have a reputation for integrity.

In making the assessment of whether a non-U.S. regulatory regime is adequately enforced, U.S. insurance regulators will rely on matters such as:

(a) the international reputation of that regulatory regime;
(b) self-assessments by the non-U.S. regulator; and
(c) assessments by international financial institutions and other international organizations.

Why has this principle been proposed?

A regulatory regime that is inadequately enforced in its home jurisdiction will not be sufficiently equivalent to the U.S. regulatory regime. Unless a regulatory regime is adequately enforced, it will frequently be ignored and, consequently, it will not reliably achieve solvency protection of the insurance marketplace.

Principle 9

An equivalent regulatory regime achieves equivalent outcomes to the U.S. regulatory regime

What does the principle mean?

Whatever its regulatory mechanisms, an equivalent regulatory regime must achieve, in the relevant areas, equivalent outcomes to the U.S. regulatory regime.

U.S. laws on financial services promote the provision of efficient, honest and fair financial services by ensuring that financial services are provided by persons who:

(a) are fair and honest;
(b) are competent to provide the financial services; and
(c) have adequate resources.

The RSRD shall create and maintain a list of non-U.S. regulatory regimes that it considers functionally equivalent regulatory regimes comparable to NAIC-accredited regulators in terms of solvency regulation, the laws and regulations it administers, the competence of its staff, and such other criteria as the RSRD deems relevant.