NEWSSTAND

NAIC Paves the Way for the Modernization of U.S. Reinsurance Regulation

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At its December 2008 Winter Meeting, the National Association of Insurance Commissioners ("NAIC") adopted, in plenary session, the reinsurance regulatory modernization proposal ("Proposal") drafted and previously adopted by the Reinsurance Task Force of the Financial Condition (E) Committee. If implemented, the Proposal would significantly reform existing state-based reinsurance regulation. Under current law, U.S. ceding insurers may only take full statutory statement credit if the assuming reinsurer is authorized or accredited in the ceding insurer's domiciliary state, or if it posts collateral sufficient to cover 100% of the policyholder liabilities assumed. The Proposal would modernize the existing regime by allowing ceding insurers to take credit for reinsurance assumed by unauthorized, unaccredited reinsurers without requiring as much, or in some cases, any collateral depending on a ratings-based system. This article summarizes some of the key aspects of the Proposal.

Creation of New Classes of Reinsurers and a Single Regulator System

The Proposal contemplates establishment of a single U.S. regulator system with two new classes of reinsurers: (1) "national reinsurers" which are U.S. reinsurers licensed and domiciled in one state (known as the "home state") that are permitted to conduct business in that state and the entire domestic market, and (2) point of entry reinsurers ("POE reinsurers") which are non-U.S. reinsurers certified by a point of entry U.S. state ("POE state") to provide creditable reinsurance to the U.S. market. A single state would be responsible for regulating each national reinsurer and POE reinsurer - either the home state or the POE state.

With respect to national reinsurers, the home state supervisor would be responsible for, among other things, approving licensure, conducting solvency exams, ensuring compliance with applicable law, establishing and adjusting the reinsurer's rating for collateral purposes, responding to inquiries from other supervisors regarding national reinsurers domiciled in the home state, initiating enforcement actions against such national reinsurers, notifying the ceding insurers' domiciliary states (known as the "host state") of such actions, and receiving annual fees from each national reinsurer it supervises.

With respect to POE reinsurers, the POE state supervisor would be responsible for, among other things, entering into a supervisory recognition framework with supervisors in non-U.S. jurisdictions, certifying POE reinsurers, establishing and adjusting the reinsurer's rating for collateral purposes, responding to inquiries from other supervisors regarding any POE reinsurer under its supervision, consulting with non-U.S. regulators regarding any issues with POE reinsurers, advising all host states of such issues, and receiving annual fees from each POE reinsurer it supervises. Additionally, POE reinsurers must file certain reports with and make certain notifications to the POE state supervisors. These reports and certifications include, but are not limited to, a notification within 10 days of any ratings or license change, submission on an annual basis of audited financial statements (preferably prepared in accordance with U.S. GAAP), and submission on an annual basis of a list of all disputed and overdue reinsurance claims assumed from a U.S. ceding reinsurer.

Under the Proposal, reinsurers are not required to become national or POE reinsurers. Reinsurers that do not wish to become national or POE reinsurers may continue to conduct business under the existing regulatory framework in accordance with the current NAIC Model Credit for Reinsurance Law as adopted by the states.

Role of the RSRD

In order to qualify as a home state or POE supervisor, the Proposal contemplates creation of a new NAIC Reinsurance Supervision Review Department ("RSRD") to evaluate and establish standards for such supervisors. Additionally, the Proposal charges the RSRD with the responsibility to evaluate the regulatory framework of non-U.S. jurisdictions for the purpose of identifying a list of recognized jurisdictions from which non-U.S. reinsurers may apply for licensure as POE reinsurers. The RSRD is charged with, among other things, development of a sample mutual supervisory recognition agreement and a protocol for recognizing non-U.S. jurisdictions, and a sample information sharing and regulatory cooperation agreement between recognized non-U.S. jurisdictions and the POE supervisor. It will also act as a repository for relevant data concerning reinsurers and the reinsurance marketplace.

To further clarify RSRD's operational structure, the NAIC adopted the following Statement of Principles for the Creation of the RSRD: (1) the RSRD should be created as a transparent, publicly accountable entity (contemplated to be part of the NAIC), with a governing board consisting of state or district insurance regulators, and with director eligibility open to all state or district insurance commissioners, directors and superintendents, and (2) RSRD criteria relating to ceded premium volume will not unfairly discriminate against otherwise qualified small jurisdictions from approval as a home state or a POE supervisor.

The Proposal recommends federal enabling legislation to provide the RSRD with sufficient authority to fulfill its functions.

Collateral Requirements

If implemented, the Proposal would reduce the amount of collateral an unauthorized, unaccredited reinsurer must post in order for an admitted, ceding insurer to take financial statement credit. Under the Proposal, the home state or POE supervisor is charged with rating national and POE reinsurers on a legal entity basis for the purpose of determining collateral requirements. The requirements depend on a sliding scale: tier 1 – 0% collateral; tier 2 – 10% collateral; tier 3 – 20% collateral; tier 4 – 75 % collateral; and tier 5 – 100% collateral. A reinsurer in the top tier would not need to post any collateral, whereas a reinsurer in the lowest tier would need to post collateral sufficient to cover 100% of policyholder liabilities in order for the ceding insurer to take financial statement credit. However, with respect to national reinsurers, as U.S. state law protects policyholders and ensures stability of the U.S. financial system, such reinsurers would not have to post collateral if they are rated in tier 3 or better by their home state supervisor.

In determining a reinsurer's rating, the home state or POE supervisor would review the reinsurer's financial strength rating, which the reinsurer must obtain from at least two rating agencies approved by the U.S. Securities and Exchange Commission. Failure to obtain or maintain such ratings would result in assignment of the lowest rating, which corresponds to a requirement that the reinsurer post 100% collateral in order for the ceding insurer to obtain financial statement credit. Additionally, the home state or POE supervisor would consider the following in determining the reinsurer's rating: (1) participation in any solvent scheme of arrangement involving U.S. cedents (if so, the reinsurer would be assigned a tier 5 rating); (2) the reinsurer's compliance with contractual terms and obligations (including certain clauses mandated by the Proposal); (3) the business practices of the reinsurer in dealing with its ceding insurers; (4) the reinsurer's reputation for prompt payment of claims; (5) regulatory actions against the reinsurer; (6) an independent audit opinion for the reinsurer; (7) the liquidation preference of obligations to a ceding insurer in the reinsurer's domiciliary jurisdiction; and (8) the most recent NAIC Filing Black Schedule F for property and casualty insurer or Schedule S for life, accident and health insurers, which detail liabilities assumed from U.S. ceding insurers. For POE reinsurers, the POE supervisors would also review audited financial statements, preferably completed in accordance with U.S. GAAP.

Implementation of the Proposal

The Proposal contemplates implementation through federal regulation in order to promote uniformity across the 50 states and the District of Columbia. Many industry groups support the Proposal and believe that its implementation would create a level playing field between domestic and foreign reinsurers resulting in lower costs for consumers, whereas others are concerned that given the current economic climate, it is not the right time to modify collateral rules and increase the uncertainty that U.S. insurers will receive prompt payments of amounts due under contracts with unauthorized, unaccredited reinsurers.

Conclusion

If adopted, the Proposal would significantly reform current state-based reinsurance regulation, and potentially open up the domestic market to more non-U.S. reinsurers. As of the date of this article, the NAIC has not promulgated a Model Law suggesting language to implement the Proposal. One state, New York, has proposed a rule similar to the Proposal and accepted comments with respect to that rule until February 6, 2009.

We will continue to monitor this topic, including the NAIC implementation process and the status of the New York rule, and we direct you to the EAPD website www.eapdlaw.com and the blog www.InsureReinure.com for further developments.