

## NAIC Pursues Revised Reinsurance Collateral Requirements

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The National Association of Insurance Commissioners (“NAIC”) adopted the Reinsurance Regulatory Modernization Framework (the “Framework”) at the NAIC Winter 2008 National Meeting. The Framework would modernize and dramatically alter the current state-based regulation of reinsurance. Since the conceptual framework requires federal legislation to implement its objectives, the Reinsurance Task Force (the “Task Force”) of the NAIC issued an exposure draft of proposed federal legislation on March 24, 2009, titled the Reinsurance Regulatory Modernization Act of 2009 (the “Modernization Act”). The Modernization Act has since been subject to significant public comment. After incorporating and addressing a number of the comments it received, the Task Force exposed a revised draft of the Modernization Act for further public comment, on July 27, 2009. On Sept. 3, 2009, the Task Force released another revised draft reflecting nonsubstantive revisions to the July 27, 2009 draft, including additional comment letters submitted by interested parties regarding the Modernization Act. The Task Force adopted the Sept. 3, 2009 draft and forwarded the proposed federal legislation to the NAIC Government Relations Leadership Council (“GRLC”) for review and consideration. On Sept. 23, 2009, at the NAIC Fall 2009 National Meeting, the GRLC approved the submission of the Modernization Act to the United States Congress.

### Current Credit-for-Reinsurance Rules

Under current credit-for-reinsurance rules, insurers are permitted to take credit on their financial statements for the reinsurance they cede, if the assuming reinsurer is authorized or accredited in the state of the ceding insurer. If the reinsurer is not authorized or accredited, it is unauthorized and is required to post appropriate collateral equal to 100 percent of its gross actuarially estimated reinsurance liabilities. State authorization or accreditation of a reinsurer requires an application process and subjects the reinsurer to the state’s jurisdiction and some of its laws and regulations. Many insurers do not wish to be subject to this process and these requirements for a variety of reasons, including tax consequences applicable to certain alien reinsurers.

Alien reinsurers have particularly denounced these collateral requirements, arguing that they tie up capital, create significant costs for doing business in the United States, and place them at a disadvantage against their United States competitors, who are not necessarily burdened by the same requirements in non-U.S. jurisdictions. Some alien insurers and reinsurers operate through United States subsidiaries in order to avoid these burdensome requirements. Critics of the current system also argue that restricting availability of capital from alien reinsurers limits competition. Of course, this could theoretically affect pricing for reinsurance.

### Abstract

*Unauthorized reinsurers have been required throughout the United States to post collateral to secure their obligations under reinsurance contracts entered with ceding carriers. However, there has been a lot of pressure over the last few years, principally from the international reinsurance community, to change the standard United States collateral requirements for reinsurance agreements. The National Association of Insurance Commissioners has taken this issue up and has recently approved a Reinsurance Regulatory Modernization Act and a Modernization Framework that would dramatically alter the reinsurance collateral requirements, which exist today for unauthorized reinsurers. The Modernization Act will have to be passed by Congress. The authors review some of the main provisions of the NAIC’s Modernization Act and discuss some of the significant issues which will need to be addressed as part of the legislative process.*

Some insurers are in favor of keeping the current credit-for-reinsurance rules because the required posting of collateral provides security to the ceding insurer. If the reinsurer is not required to post collateral, ceding insurer solvency issues related to difficulties in the collection of reinsurance recoverables could arise and, at the least, it is feared that collection could be compromised by shifting negotiating leverage to the benefit of the reinsurer, especially if the reinsurer is located in a foreign country.

Another issue involves the fairness of the requirement to post collateral. Alien reinsurers are not necessarily subject to United States tax laws, which are generally imposed on U.S. domiciled reinsurers. This tax insulation has been used as partial justification that it is fair to impose collateral requirements on alien reinsurers. To the extent alien reinsurers are not required to post collateral to engage in reinsurance in the United States, some domestic insurers argue this, along with the continuation of the tax exemption, will provide the alien reinsurers with an unfair competitive advantage.

### Summary of Proposed Legislation

The United States, which is the largest reinsurance market in the world, is the only major market that imposes such collateral rules. Some in the insurance industry believe the time is right for change. In 2007, the NAIC charged the Task Force with the responsibility of considering alternatives to the current regulatory framework, which provides credit for reinsurance. Specifically, the Task Force was asked to develop methods of assessing the strength of reinsurers, regardless of their state or country of domicile. Subsequently, the Task Force studied and considered a ratings-based system that would serve to supplement or replace current collateral requirements for foreign and alien reinsurers. Under a ratings-based system, a regulatory system would be established that would require the reinsurer to post collateral based on the financial strength of a reinsurer, the depth and quality of regulatory oversight of the reinsurer's state or country of domicile and a variety of other factors.

The following is a brief summary of select provisions of the draft of the Modernization Act adopted by the NAIC. The Modernization Act proposed by the NAIC establishes two types of reinsurers in the United States: National Reinsurers and Port of Entry ("POE") Reinsurers ("POE Reinsurers").<sup>1</sup> National Reinsurers are U.S. domiciled reinsurers and POE Reinsurers are non-U.S. reinsurers.<sup>2</sup> Each type of reinsurer would be supervised by a single state; either the Home State (where the National Reinsurer is licensed and domiciled) or the POE State (where a non-U.S. assuming reinsurer is certified to provide creditable reinsurance to ceding insurers).<sup>3</sup>

The Modernization Act establishes the Reinsurance Supervision Review Board (the "Board"), an agency of the United States, comprised of 10 insurance regulators and five representatives of U.S. agencies as appointed by the president and with the advice and consent of the Senate.<sup>4</sup> The Board would have the authority to evaluate the regulatory systems of the states to determine if they qualify as Home State Supervisors or POE Supervisors.<sup>5</sup> The Board also has authority to evaluate reinsurance supervisory systems of non-U.S. jurisdictions to determine if they are eligible as a qualified jurisdiction under NAIC standards.<sup>6</sup>

The Modernization Act would authorize a certification mechanism allowing states demonstrating requisite resources, expertise and experience to regulate reinsurers on a cross-border basis to serve as the Home State for U.S. domiciled reinsurers or POE State for non-U.S. reinsurers.<sup>7</sup> POE Supervisors would be authorized by the Modernization Act to enter into reciprocal recognition agreements.<sup>8</sup> Additionally, a POE State would be authorized to enter into information-sharing agreements with qualified non-U.S. jurisdictions, in accordance with NAIC standards and procedures adopted by the Board.<sup>9</sup>

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This authorization is intended to eliminate constitutional concerns about possible violations of the Compact Clause of the United States Constitution, which prohibits states from entering into “any Agreement or Compact with another State, or with a foreign Power,” without the consent of Congress.<sup>10</sup>

Under the Framework and Modernization Act, reinsurers would be required to have at least \$250 million in capital and surplus for eligibility as either a National Reinsurer or POE Reinsurer.<sup>11</sup> This surplus requirement could be satisfied by a group including a number of underwriters having the required capital and surplus and a central fund of at least \$250 million.<sup>12</sup> In order to be certified as a POE Reinsurer, a company would be required to be organized in and licensed by an eligible non-U.S. jurisdiction.<sup>13</sup> The Board would determine eligibility of non-U.S. jurisdictions.<sup>14</sup>

Credit for reinsurance ceded by a U.S. domiciled insurer to a National Reinsurer or a POE Reinsurer would be granted in accordance with the standards set forth in the Framework and Modernization Act.<sup>15</sup> The amount of collateral a reinsurer would be required to post under the Framework would be based on an evaluation by its Home State or POE Supervisor, as applicable.<sup>16</sup> These supervisors would utilize standards recommended by the NAIC and adopted by the Board to determine the rating (financial strength) of a reinsurer.<sup>17</sup> Ultimately, the supervisor would assign a reinsurer one of five ratings regarding the financial strength of the reinsurer.<sup>18</sup> These ratings range from various levels of “secure,” which would require the posting of no or staggered percentages of collateral, to “vulnerable,” which would require the posting of 100 percent collateral.<sup>19</sup>

A Home State or POE Supervisor would utilize Board-approved standards, which would include, among others, such considerations as:

- Financial strength ratings from at least two qualified rating agencies.
- Compliance with reinsurance contracts.
- The business practices of the reinsurer in dealing with its ceding insurers.
- For National Reinsurers, a review of the most recent NAIC Annual Statement Blank.
- For POE Reinsurers, a review of a report filed annually in the form of the applicable NAIC Annual Statement Blank.
- The reinsurer’s reputation for prompt payment of claims.
- Regulatory actions against the reinsurer.
- Report by an independent auditor on the reinsurer’s financial statements.
- For POE Reinsurers, audited financial statements, regulatory filings and actuarial opinions.
- The liquidation priority of obligations to a ceding insurer in the reinsurer’s domiciliary jurisdiction in an insolvency proceeding.
- A reinsurer’s participation in any solvent scheme of arrangement, or similar procedure, which involves U.S. ceding insurers.
- Any other information deemed relevant by the home state or POE supervisor.<sup>20</sup>

Under the Framework, insurers providing reinsurance are required to operate under the Modernization Act, as all laws, regulations, provisions and other actions of a state are preempted to the extent that they are inconsistent with the Modernization Act.<sup>21</sup> However, the Modernization Act does not preempt any state law, rule or regulation that regulates credit for reinsurance ceded to reinsurers that are not National or POE Reinsurers, as defined by the Act.<sup>22</sup>

## Industry Comments

The industry and other interested parties submitted a substantial number of comments on the drafts of the Modernization Act. The Modernization Act provides for different standards pertaining to the amount of collateral which must be posted by a reinsurer depending upon whether that reinsurer is a National Reinsurer or a POE Reinsurer. The higher rated classes of “secure” National Reinsurers would not be required to post collateral, whereas those same classes of “secure” POE Reinsurers would be required to post collateral. Some have commented that the Modernization Act would afford preferential treatment to U.S. reinsurers. The Task Force responded by stating the Modernization Act is an initial step in the modernization effort and represents a substantial change from current credit-for-reinsurance rules. In addition, these provisions are subject to review two years after the effective date of the Modernization Act.

Some interested parties expressed concern with possible constitutional issues with the Modernization Act. As previously indicated, this relates to the general prohibition of states from entering into agreements with foreign countries without the consent of the Congress. Initially, there was concern with the delegation of authority to the original Board, to which the NAIC appointed Board members, as it would have constituted an improper delegation of legislative and executive power to a private institution without federal oversight. Another constitutional argument centered upon the assertion that since Congress does not have the authority to command state action, provisions in the Modernization Act requiring state supervisors to take action with regard to capital and surplus, financial statements and security requirements may be construed as a violation of the Constitution. The Task Force sought the advice of a constitutional law expert and many issues were corrected. Some of the changes that were made as a result of these comments were the composition of the Board and the appointment by the President. Some industry representatives believe that there are still unresolved constitutional issues with the Modernization Act.

Some industry members were concerned that some reinsurers would have to post 100 percent collateral in the event of insolvency of the ceding company. They believed that a ceding insurer’s solvency does not change the credit quality of the reinsurer because there is no correlation between ceding insurance company insolvency and reinsurer financial difficulties. In fact, A.M. Best published a report that indicated that reinsurance failures are rarely the cause for ceding company insolvencies. The Task Force simply thanked these members for their comments and did not change the subject provisions.

Others expressed a more basic concern that the elimination of collateral with regard to reinsurance obligations could impair the ability of ceding insurers to collect reinsurance proceeds thereby impairing some ceding insurers who often rely on the reinsurance collateral as a security bedrock in their operations. It was pointed out by one industry association that the Oversight and Investigations subcommittee of the U.S. House Energy and Commerce Committee had concluded that the inability of U.S. insurers to collect reinsurance payments from alien reinsurers was a critical factor in the U.S. insurer insolvencies in the 1980s. This association noted that since the subsequent enactment of the credit-for-reinsurance laws, the failure to collect reinsurance

recoverables has not been a critical factor in any U.S. insurer insolvencies. Again, the Task Force simply thanked these members for their comments and did not change the subject provisions.

To date, some parties continue to take the position that the current credit-for-reinsurance rules serve their purpose and no change is required. Others have commended the NAIC for initiating a change in the current rules governing reinsurance. Many commentators are still concerned with the constitutionality of the Modernization Act and the broad authority given to the Board. These comments suggest that the Modernization Act needs to be further revised to address the constitutional issues raised, including arguments regarding the scope of the federal government's authority and possible vagueness of some of the provisions of the Modernization Act. Furthermore, many international reinsurers are concerned with the accounting and financial statements required of the Modernization Act and whether their financial statements will be acceptable to the NAIC.

### **Specific State Action**

Some states have decided to take action without waiting for a resolution of the issue by the NAIC and the Federal Government. For example, on Sept. 16, 2008, Florida adopted a new regulation that authorizes the insurance commissioner to establish lower collateral requirements. The new regulation applies to unauthorized and unaccredited foreign and alien reinsurers that have financially secure ratings from at least two nationally recognized rating organizations and meet certain eligibility standards, such as maintaining surplus over \$100 million and being authorized in their domiciliary jurisdiction for the types of insurance to be ceded.<sup>23</sup> After eligibility is determined, the amount of collateral the reinsurer is required to post is determined by the Rule, which contains a schedule. The higher a reinsurer's financial strength rating, the less collateral the reinsurer is required to post. Florida's ratings-based collateral rule applies only to reinsurance ceded by Florida domestic property and liability insurers.

On Dec. 24, 2008, the New York State Insurance Department published its proposed tenth amendment to a regulation relating to the ratings-based reinsurance collateral issue.<sup>24</sup> Although similar to the NAIC proposal, the New York regulation only applies to non-U.S. reinsurers. Like the Florida rule, the New York regulation sets collateral based on reinsurer financial strength ratings from at least two recognized rating agencies; however, it requires the unauthorized assuming reinsurer to maintain a minimum net worth of \$250 million and be authorized by, and meet solvency and capital standards of, its domiciliary jurisdiction. The highest-rated reinsurers would not be required to post any collateral, while lowest-rated reinsurers would be required to post collateral ranging from 10 percent to 100 percent of their reinsurance obligations. As of the date of the completion of this article, the Department was reviewing and evaluating public comments, on its proposed regulation.

### **Conclusion**

The issues and comments raised with regard to the efforts to modernize the collateral requirements under reinsurance contracts evidences the pervasiveness of the impact of these proposed changes on the insurance industry. It is expected that significant discussion will continue on the Modernization Act as the Act proceeds through the legislative process. At the time this article was finalized, the GRLC had approved the Modernization Act and it will now become part of the legislative process in Congress.

## Endnotes

1. The Reinsurance Regulatory Modernization Act of 2009 § 2 (The National Association of Insurance Commissioners Reinsurance Task Force Adopted Sept. 15, 2009) [hereinafter MODERNIZATION ACT].
2. MODERNIZATION ACT § 2.
3. MODERNIZATION ACT §§ 4, 10(10), (18).
4. MODERNIZATION ACT § 3.
5. MODERNIZATION ACT § 4(b), (e).
6. MODERNIZATION ACT § 4(c), (f).
7. See MODERNIZATION ACT §§ 4(e)-(f), 5.
8. MODERNIZATION ACT § 4(h).
9. MODERNIZATION ACT § 4(h).
10. U.S. CONST. art. 1, § 10, cl. 3.
11. MODERNIZATION ACT § 5(a).
12. MODERNIZATION ACT § 5(a).
13. MODERNIZATION ACT § 10(17).
14. MODERNIZATION ACT § 4(c).
15. MODERNIZATION ACT § 5(b).
16. See MODERNIZATION ACT § 5(b).
17. MODERNIZATION ACT § 5(b)(1), (4).
18. MODERNIZATION ACT § 5(b)(1).
19. MODERNIZATION ACT § 5(b)(1).
20. MODERNIZATION ACT § 5(b)(4)(A)-(L).
21. See MODERNIZATION ACT § 6.
22. MODERNIZATION ACT § 6(d).
23. FLA. STAT. § 624.610 (2009); FLA. ADMIN. CODE ANN. r. 690-144.007 (2009).
24. Tenth Amendment to N.Y. COMP. CODES R. & REGS. tit. 11, § 125 (Regulation No. 20).