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NAIC adopts its Reinsurance Regulatory Modernization Framework:

A proposal modifying collateral requirements for foreign reinsurers

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On December 7, 2008, the plenary session of the National Association of Insurance Commissioners (NAIC) adopted its Reinsurance Regulatory Modernization Framework Proposal (the Proposal). Adoption of the Proposal marks a substantial step towards reforming U.S. state-based regulation of reinsurance collateral requirements and movement toward more uniform standards applicable to domestic and foreign reinsurers.

Under the current reinsurance regulatory model, all non-U.S. licensed reinsurers must post collateral (generally in the form of unconditional letters of credit, cash, securities, or an approved trust fund) for 100 percent of the reinsurance obligations for domestic ceding companies to receive financial statement credit. In comparison, a licensed or accredited U.S.-domiciled reinsurer need not post collateral for a cedent to receive credit, regardless of its financial strength. Collateral requirements and the concomitant regulation of credit significantly impact the domestic reinsurance market because ceding companies will only choose reinsurance that provides them with financial statement credit.

Questioning the possible inequities of the indiscriminate collateral requirement for non-U.S. reinsurers, on March 5, 2006, the Executive Committee of the NAIC charged the Reinsurance Task Force (RTF) to ”develop alternatives to the current reinsurance regulatory framework, including the U.S. and abroad” and to “consider approaches that account for a reinsurer’s financial strength regardless of domicile, i.e., state or country.” Tasked with amending collateral requirements, the RTF worked for two years to fashion a new framework. This recently adopted Proposal was borne from two previously rejected RTF proposals and substantially revamps the reinsurance regulatory scheme.

Evolution of the Adopted Proposal

On December 10, 2006, the RTF presented its first proposal entitled”NAIC Reinsurance Evaluation Office - Proposal to Grant Credit for Ceded Reinsurance” (the REO Proposal). The REO Proposal sought to establish an entity within the

NAIC called the”Reinsurance Evaluation Office” (the REO). One of the REO Proposal’s key innovations was the development of a rating system that would apply to foreign and domestic reinsurers alike. Under this system, the REO was to evaluate the financial strength of foreign and domestic reinsurers and assign each company a rating ranging from”REO-1” to”REO-6.” In addition to other factors, the assigned ratings were to be largely based upon the ratings issued by national rating organizations, such as Standard & Poors. Each of the six rating categories would carry a corresponding collateral requirement. For example, foreign or domestic reinsurers rated REO-1 would enjoy a zero percent collateral requirement. In other words, no collateral need be posted for the ceding company to take full credit for reinsurance assumed by companies rated REO-1. Each successive REO ranking would suffer a 20 percent incrementally increased collateral requirement. Thus, companies rated REO-2 would be required to post 20 percent collateral, while a rating of REO-6, the poorest possible rating, required 100 percent collateral.

The REO Proposal is noteworthy because the scaled collateral requirements would have applied equally to foreign and domestic reinsurers. Despite its novel approach to equalizing collateral obligations, the REO Proposal was ultimately rejected. Among other concerns, regulators noted that the Proposal granted the REO too much unchecked authority and that the proposal created little incentive for domestic reinsurers to maintain their U.S. licenses.

The RTF went back to the drawing board. On September 7, 2007, the RTF released for comments an amended proposal (the RSRD Proposal). The RSRD Proposal provided for the creation of a new entity called the”NAIC Reinsurance Supervision Review Department” (the RSRD). In response to the earlier concerns regarding the proposed REO organization, the RSRD was envisioned as an entity exercising limited authority.

The RSRD Proposal retained vestiges of the stepped-up rating system first unveiled in the REO Proposal. Of greatest significance, however, the RSRD Proposal did not call for uniform collateral requirements for foreign and domestic reinsurers. Under the RSRD Proposal, any state in the Union could apply to the RSRD to become an accredited ”port of entry” state (POE state). After accreditation, a POE state would be permitted to evaluate certification applications from foreign reinsurers wishing to write assumed business in the United States. In addition to other criteria, a non-U.S. reinsurer could not be certified unless the company was domiciled and licensed under a ”functionally equivalent jurisdiction.”

After determining that certification was proper, under this second proposal the POE state regulator would assign a rating ranging from Class 1 through Class 5, with respective collateral amounts of 60 percent (Class 1), 70 percent (Class 2), 80 percent (Class 3) or 100 percent (Classes 4 and 5). Like the REO Proposal, the RSRD Proposal envisioned that POE state regulators would rely on national rating organizations in determining the appropriate rating. While foreign reinsurers boasting the strongest rating (Class 1) would be required to post 60 percent collateral for the reinsured obligation, domestic reinsurers would not be subject to such draconian collateral requirements. Only those domestic reinsurers with the poorest financial ratings, or those that did not maintain adequate capital or a minimum financial strength, would have to post collateral.

Like the first proposal, the RSRD Proposal was also rejected. Among other concerns, the RSRD Proposal was criticized as being inconsistent with the RTF's original charge to equalize the U.S. reinsurance regulatory framework. Other regulators and industry experts noted that key concepts in the Proposal were too vague, such as "functionally equivalent jurisdictions" or "accredited" POE states. After the comment period, the RTF made significant modifications to the RSRD Proposal to create the Proposal now adopted by the NAIC.

Anatomy of the Adopted Proposal

The recently adopted Proposal creates two new classes of reinsurers in the United States -"national" domestic reinsurers and "port of entry" (POE) foreign 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 port of entry state and approved by such state to provide creditable reinsurance to the U.S. market."

Unlike the cumbersome fifty state regulatory status quo, the Proposal establishes a regime in which a single qualifying state would be the sole U.S. regulator of a national or POE reinsurer writing assumed business across the United States. In that regard, the Proposal distinguishes between "home" and "host" states. A home state is "the qualifying state where the national reinsurer is licensed and domiciled." A host state is defined as "the domicile of the ceding company." A domestic or foreign reinsurer not eligible for or interested in seeking certification as a national or POE reinsurer could continue operating under the current regulatory framework.

In order to establish uniform standards, the current Proposal, like its RSRD Proposal predecessor, also provides for the establishment of the NAIC Reinsurance Supervision Review Department (RSRD). The RSRD is envisioned as a transparent and publicly accountable entity within the NAIC. A supervisory board of the RSRD (consisting of state insurance regulators) would, among other tasks, establish uniform standards for determining POE state and/or home state supervisor certification and resolve disputes between home and host states. During the home state supervisor or POE supervisor qualification process, the following benchmark standards, among other criteria, would be considered by the RSRD: state experience in regulating sophisticated market participants, depth and quality of department staff, accreditation through the NAIC's Financial Regulation Standards and Accreditation Program and experience in regulating reinsurance transactions.

A second key function of the RSRD would be to evaluate the regulatory regimes of non-U.S. jurisdictions and generate a list of foreign jurisdictions eligible to be recognized by POE states. The Proposal envisions that mutual cooperation agreements will be entered into between POE/home state supervisors and such eligible jurisdictions. A non-U.S. reinsurer located within such an eligible jurisdiction could then apply to qualified POE states to become a certified POE reinsurer. Host states do, however, retain the ability to determine if risk is transferred in reinsurance agreements with cedents domiciled in that state.

In order to be licensed as a national reinsurer or certified as a POE reinsurer, the reinsurer must ”have a minimum capital and surplus requirement of $250 million.” The $250 million requirement could also be satisfied by a recognized underwriter (such as Lloyd’s)”having minimum capital and surplus equivalents (net of liabilities) of at least $250 million and a Central Fund containing a balance of at least $250 million.” Once a reinsurer is licensed as a national reinsurer or certified as a POE reinsurer, a host state would be required to grant credit for reinsurance ceded by one of its domestic reinsurers to either a national or POE reinsurer.

As a means of eradicating the indiscriminate universal 100 percent collateral requirement presently imposed on foreign reinsurers, the Proposal establishes a sliding scale rating system for assessing collateral obligations. The home state supervisor or POE supervisor would be responsible for assigning the appropriate rating to its national and POE reinsurers respectively - based on the ratings of at least two recognized ratings agencies and other factors deemed significant by the POE/home state supervisor. The stepped-up ratings and corresponding collateral calculations are as follows: Secure-1 (0% collateral); Secure-2 (10% collateral); Secure-3 (20% collateral); Secure-4 (75% collateral); and Vulnerable-5 (100% collateral). Although this sliding scale makes strides toward equalizing regulatory treatment of foreign and domestic reinsurers, pursuant to the Proposal, national reinsurers rated Secure-3 or above would not have to post any collateral. In contrast, POE reinsurers rated Secure-3 or above would be subject to the scaled percentage collateral obligations referenced above. For those national reinsurers that are rated Secure-4 or Vulnerable-5, the 75 and 100 percent collateral requirements applicable to POE reinsurers would be respectively imposed.

As evidenced by the evolution of the adopted Proposal, the RTF has grappled with how to achieve its objective of developing ”geographically agnostic” collateral requirements. Under the adopted Proposal, collateral obligations are not equally imposed upon similarly situated domestic and foreign reinsurers rated Secure-3 and above. The Proposal states that the more lenient collateral requirements for national reinsurers rated Secure-3 and above are possible due to the ”prudential U.S. reinsurance regulatory requirements designed to protect policyholders and ensure the integrity and stability of the U.S. financial system.” Perhaps, with its adoption of the current Proposal, the NAIC has tacitly conceded that it cannot, or will not, ”account for a reinsurer’s financial strength regardless of domicile.”

As mentioned above, the Proposal provides that domestic and foreign reinsurers may continue to operate under the current regulatory framework. Whether it will be advisable for a reinsurer to apply for national or POE status presents differing considerations depending on whether the reinsurer is U.S.-based or not. While the Proposal fails to provide details regarding the extent and cost of the application process, it is certain that both domestic and foreign reinsurers will need to engage in thorough cost-benefit analyses before seeking national or POE reinsurer status. For example, in light of the current difficult market conditions, the Proposal as presently structured may create a disincentive for certain domestic reinsurers to seek"national" reinsurer status. The Proposal specifies the ratings necessary to achieve Secure-1, Secure-2, and Secure -3 ratings. They are:

Rating	Best	S&P	Moody's	Fitch
Secure-1	A++	AAA	Aaa	AAA
Secure-2	A+	AA(+or-)	Aaa (1-3)	AA(+or-)
Secure-3	A, A-	A (+or-)	A(1-3)	A(+or-)

As a result of reductions in asset values and reduced revenues due to the current financial downturn, only a small number of reinsurers have current financial ratings eligible for Secure-1 or Secure-2 ratings under the Proposal. A significantly greater number of companies are currently rated at levels more consistent with Secure-3 or below.

Under the current regulatory model, a domestic reinsurer that is unable to secure two ratings from recognized national rating organizations need not post collateral. However, if such a domestic reinsurer were to become licensed as a national reinsurer and then be unable to secure ratings from two national ratings agencies or have its ratings drop to levels no longer supportive of a Secure-3 rating, the company would likely be subject to a 75 or 100 percent collateral requirement. Such a domestic reinsurer will need to carefully consider the potential for deterioration of its rating and the imposition of collateral requirements under the Proposal.

When deciding whether to continue operating under the current regulatory model, foreign reinsurers will need to address vastly different considerations than their domestic counterparts. Due to the blanket collateral requirement presently imposed upon foreign reinsurers, it would be likely that most eligible foreign reinsurers would seek POE certification - no matter their financial strength. After obtaining POE certification, many foreign reinsurers would enjoy the significantly lower collateral requirements attendant to a Secure-1 through Secure-4 rating. Most foreign reinsurers stand to gain the benefit of a lower collateral requirement under the Proposal.

The RTF recommends implementation of the Proposal through federal enabling legislation. Such legislation would permit greater uniformity of application and alleviate some concerns regarding possible constitutional issues. During previous comment periods, commentators and regulators questioned the constitutionality of state (or RSRD) mutual cooperation agreements and information-sharing with foreign jurisdictions. The RTF has noted that both state and federal legislation may be necessary to completely implement the Proposal. Federal legislation will establish the authority of the RSRD to negotiate with foreign jurisdictions and clarify the scope of such agreements. State legislation will establish supervisory authority in each POE or Home state.

Conclusion

The Proposal offers only an initial framework which must be developed into concrete statutory proposals and ultimately legislatively adopted by the states. The RTF has been charged with overseeing the establishment of greater definition and detail to the proposal. As with all regulatory proposals, the ”devil is in the details.” Here these details will entail: requirements for home state/POE state certification; criteria for eligible jurisdictions for POE reinsurers; and the parameters of the federal legislation to be sought. Cedents, as well as foreign and domestic reinsurers, will be watching these developments carefully to assess their ultimate effects. Saul Ewing’s Insurance Group will be tracking developments of this Proposal and will report as significant events occur.

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