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Reinsurance Regulatory Modernization

Robert B. Kasinow
Chief Insurance Examiner
New Jersey Department of Banking and Insurance
Robert.Kasinow@dobi.state.nj.us

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Reinsurance Regulatory Modernization

- U.S. Regulatory Approach to Reinsurance Regulation
- Recent History of the NAIC Debate
- 2008 Reinsurance Modernization Proposal
- Collateral Debate: Pros and Cons
- Critical Concerns

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U.S. Regulatory Approach

- Focuses on ceding company solvency
  - Consider the impact of reinsurance on the ceding company's financial condition, and ultimately the financial impact on consumers of insurance products.
  - Presumption exists for relative equality of negotiating leverage between buyer and seller of reinsurance products
    - Market conduct concerns relating to rate and form filing are therefore not a primary concern for regulators in the context of the reinsurance marketplace.
  - Much of the reinsurance ceded by U.S. companies goes to reinsurers domiciled outside the U.S.
    - Many of the largest, oldest, and financially strongest reinsurers are located abroad.
    - The capacity they provide is very important to U.S.

Credit for Reinsurance (NAIC Model)

Credit for reinsurance (reduce reserves by amount ceded) is allowed if:

- The reinsurer **is licensed in the same state** of domicile as the ceding company**. Or**
- The reinsurer **is accredited by the domiciliary insurance department** of the ceding company. **Or**
- **The reinsurer is domiciled and licensed in a state with similar credit for reinsurance laws as the ceding company. Or**
- **The reinsurer maintains trust funds in the U.S. Or**
- **The ceding company withholds funds or security from the reinsurer.**

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Accredited Reinsurer

- Submit to enacting state's **jurisdiction.**
- Submit to enacting state's **examination authority.**
- Reinsurer must be **licensed in at least 1 state.**
- Reinsurer must **file its annual financial statement** in ceding company's state of domicile.
- Maintain policyholder surplus of at least $**20 million.**

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Recent History

- **2001 Proposal for Approved Reinsurer Listing**
  - Create approved reinsurer list like the NAIC International Insurers Dept. (IID) does for non-U.S. Surplus Lines writers
  - Several concerns prevented action at the time
- **2003 NAIC Study on Potential Impact of Approved Listing**
  - Analyzed S&P Top 150 reinsurers as likely listing candidates:
    - 61 reinsurers met initial criteria (unauthorized & $200M Surplus)
    - NAIC research based on 50% collateral for unaffiliated transactions and 30% for affiliated transactions
      - 32 U.S. cedents with recoverable exposure of 100% of Surplus and
      - 294 U.S. cedents would be over the 10% IRIS threshold for exposure

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- 2003: Regulators ask industry participants to attempt to work out a commercial solution.
  - Interested parties could not produce a proposal
- 2004: Created Reinsurance Collateralization Roundtable (Roundtable)
  - Nine U.S. regulators, not in formal NAIC structure.
    - Arkansas, District of Columbia, California, Georgia, Illinois, Maine, New York, North Dakota, and Texas
- 2006: Reinsurance TF Adopts REO Proposal
  - Approve collateral from 0% to 100% per contract
- 2007: E Committee Charge to flesh out REO and also consider overall regulation of reinsurance

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2008 Reinsurance Regulatory Reform Framework

- Proposed Modernization Framework
  - Single state regulatory approach for U.S. & non-U.S. insurers' reinsurance business
  - Provides for two new classes of reinsurers
    - National reinsurer (U.S.)
    - Port of Entry reinsurer (non-U.S.)
  - Uniform minimum standards for supervisors and reinsurers
    - $250 million minimum capital requirement for reinsurer
    - Framework applies to "mixed" reinsurers for reinsurance business
  - Establishes collateral requirements from 0% to 100% based on a reinsurer's supervisory rating
  - Establishes NAIC Reinsurance Supervision Review Department (RSRD)

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2008 Reinsurance Regulatory Reform Framework

- **Terms**
  - **Domiciliary Jurisdiction** – insurer's place of incorporation or organization
  - **Home state** – qualifying state where national reinsurer is licensed and domiciled
  - **Home state supervisor** – supervisor of a national reinsurer
  - **Host state** – domicile of the ceding company
  - **Host state supervisor** – ceding company's domestic regulator
  - **National reinsurer** – U.S. reinsurer licensed and domiciled in a home state, and approved by home state supervisor to write reinsurance assumed business
  - **Non-U.S. jurisdiction supervisor** – domiciliary supervisor of a reinsurer from a non-U.S. jurisdiction
  - **Port of Entry (POE) reinsurer** – non-U.S. assuming reinsurer certified by POE state to provided creditable reinsurance to U.S. market
  - **POE state** – state where non-U.S. assuming reinsurer is certified
  - **POE supervisor** – insurance supervisory agency of the POE state

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2008 Reinsurance Regulatory Reform Framework

- Reinsurance Supervision Review Department
  - Evaluate/determine appropriate supervisory recognition approach for non-U.S. jurisdictions through an "outcomes oriented approach"
  - Maintain listing of eligible jurisdictions
  - Establish uniform standards and criteria for home state and POE supervisors
  - Facilitate communication and dispute resolution among supervisors
  - Maintain, revise and update collateral reduction eligibility criteria

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2008 Reinsurance Regulatory Reform Framework

- Four methods of conducting reinsurance business in the U.S.
  - As a national reinsurer (U.S.)
  - As a POE reinsurer (non-U.S.)
  - Under section 2 of the current NAIC Model Credit for Reinsurance Law, as an assuming reinsurer that is licensed, accredited or otherwise meets the requirements within Section 2 of the current NAIC model; or
  - Under section 3 of the current NAIC Model Credit for Reinsurance Law, as an assuming reinsurer, (U.S. or non U.S.) that does not meet the requirements within Section 2 of the current Model, by posting required collateral.

2008 Reinsurance Regulatory Reform Framework

- Home State Supervisor
  - Single state U.S. regulator for a U.S. reinsurer
  - Domestic reinsurer has opportunity to access U.S. market as a “national reinsurer” upon certification by a U.S. state (home state)
  - Uniform minimum standards for:
    - A domestic company to qualify for national reinsurer certification
    - A state to qualify to be recognized as a U.S. reinsurer’s home state supervisor

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2008 Reinsurance Regulatory Reform Framework

- Port of Entry (POE) Supervisor
  - Single state U.S. regulator for a non-U.S. reinsurer
  - Non-U.S. reinsurer from an RSRD-approved jurisdiction could be certified to access the U.S. market through one domestic jurisdiction (known as the reinsurer's "Port of Entry")
  - Uniform minimum standards for:
    - A non-U.S. company to qualify for certification
    - A domestic state to qualify to be recognized as a non-U.S. reinsurer's "Port of Entry"

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2008 Reinsurance Regulatory Reform Framework

- Host State Supervisor
  - U.S. ceding company's domestic regulator
  - Retains existing supervisory authority over ceding company, including:
    - Evaluation of risk transfer
    - Diversification of reinsurance risk
  - Additionally:
    - Right to request analysis or information regarding reinsurers
    - Right to completed financial analysis and exam work papers
    - Advise on reasonable cause for examination of national reinsurer
    - Right to request additional information from home state or POE supervisors regarding a national or POE reinsurer

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2008 Reinsurance Regulatory Reform Framework

- Collateral Requirements
  - Collateral requirement is based on the rating assigned to a reinsurer by the home state or POE supervisor
  - Rating evaluation is conducted on legal entity basis as opposed to a group basis
  - National Reinsurers are not required to post collateral if rated in the Secure 3 tier or above

Ratings	Collateral Required
Secure – 1	0%
Secure – 2	10%
Secure – 3	20%
Secure – 4	75%
Vulnerable – 5	100%

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2008 Reinsurance Regulatory Reform Framework

- Rating evaluation factors
  - NRSRO ratings
    - Must maintain at least two NRSRO ratings, stand alone basis
    - Matrix establishes maximum allowable reinsurer rating based on lowest NRSRO rating
  - Compliance with contractual terms and obligations
  - Business practices in dealing with ceding insurers
  - Audited financial information & other reports
  - Reputation for prompt payment of claims
  - Regulatory actions
  - Jurisdictional insolvency process
  - Other relevant information

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2008 Reinsurance Regulatory Reform Framework

- Other Collateral Considerations
  - Catastrophe recoverables
    - One year delay for posting of collateral related to catastrophe recoverables
    - Pertains to specific short-tailed lines of business only
      - Fire, Allied Lines, Farmowners multiple peril, Homeowners multiple peril, Commercial multiple peril, Inland Marine, Earthquake, Auto physical damage
  - 100% collateral required upon order of rehabilitation, liquidation or conservation against ceding insurer
  - Affiliated transactions – same opportunity for reduced collateral requirements as all other reinsurance transactions

2008 Reinsurance Regulatory Reform Framework

- Supervisory rating change or revocation
  - NRSRO downgrade or other disqualifying circumstance – no supervisory discretion to waive additional collateral requirements that result
  - Home state or POE supervisor may suspend certification, amend or withdraw rating
    - Failure to meet requirements and obligations
    - Financial or operating results
  - Supervisory rating upgrade – applies prospectively
  - Supervisory rating downgrade – applies to all business covered under this framework

2008 Reinsurance Regulatory Reform Framework

- Implementation
  - Recommendation: federal enabling legislation
    - Preserve state-based regulation of reinsurance on a cross-border basis
    - Promote uniformity of regulation throughout NAIC member jurisdictions
  - Other considerations
    - Potential changes to state insurance laws
    - Separate enactment for home state and POE supervisor qualification
    - Future amendments to the framework to maintain flexibility in cross-border regulation of reinsurance

U.S. Reinsurance Collateral Debate - Current

- Over-Funding of Liabilities: Gross vs. Net
  - **Pro-Reduction**: Insurers manage business on a net basis, yet collateral requirements require unauthorized reinsurers to operate on a gross basis by requiring 100% of gross liabilities to be funded.
  - **Pro-Maintenance**: The amount of collateral posted is only the amount that the reinsurer is *contractually liable to pay* and therefore should have already made provision. The rules only require assets to be posted in the same amount as the current estimate of liabilities incurred.

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U.S. Reinsurance Collateral Debate

- Non-U.S. Reinsurers Point to Increasing Transaction Costs for Providing Collateral
  - **Pro-Reduction**: "Higher" cost to obtain Letter of Credit
- U.S. Industry Viewpoint (Pro-Maintenance)
  - Other funding mechanisms exist that have very little cost (funds held) that are growing rapidly
  - Many U.S. ceding insurers view these costs as a small price to pay for the added security of collateral.
  - If collateral requirements were reduced, what would unauthorized reinsurers do with those funds?
    - Write more U.S. business?
    - Leverage those funds elsewhere internationally?

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U.S. Reinsurance Collateral Debate

- Non-U.S. Reinsurers Point to Reinsurance Recoverable as a Counterparty Credit Risk
  - **Pro-Reduction**, as other U.S. solvency rules do not require 100% collateral
    - For investment counterparty risk, for example
- U.S. Industry Viewpoint (Pro-Maintenance)
  - There is no secondary market to price or value reinsurance recoverables whereas there is such a mechanism for corporate bonds.
  - Reinsurance is fundamentally different from other assets, because the reinsurer's commitment is open-ended and it is given special accounting treatment
    - Netted out dollar for dollar against reserves on an undiscounted basis.

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U.S. Reinsurance Collateral Debate

- U.S. Industry Concerns for Enforceability of U.S. Judgments Abroad (Pro-Maintenance)
  – Nothing to prevent a court from refusing to enforce a judgment upon finding any of a number of exceptions
  – Collateral also aids in slow pay situations
- Non-U.S. Reinsurers and Regulators Point to Commercial Transaction (Pro-Reduction)
  – Most disputes are settled via arbitration

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U.S. Reinsurance Collateral Debate

- Collateral as a Trade Issue
  – Non-U.S. Reinsurers and Regulators:
  – **Pro-Reduction**:
    - Claim EU Reinsurance Directive does not require collateral for U.S. Reinsurers
    - Consider U.S. Collateral Requirements Discriminatory
    - 2001 international insurance industry white paper by the Financial Leaders Working Group on Insurance
      – Urge all governments to move toward freest possible movement of international reinsurance, including the elimination of discriminatory requirements for collateralization and localization of assets.

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U.S. Reinsurance Collateral Debate

- Collateral as a Trade Issue
  - U.S. Industry Viewpoint:
  - **Pro-Maintenance**
    - Collateral requirements = fundamental state based solvency regulation, so are under "prudential" carve out in int'l trade rules
    - Under int'l treaties the NAIC, states and U.S. government are not compelled to engage in trade negotiations over these rules.
    - The WTO does not have jurisdiction over state regulatory authorities, nor does the WTO tell governments how to conduct their trade policies.

Other Key Issues

- Primary issues and concerns discussed during latest revision
  - Physical U.S. presence for POE reinsurer
    - Concern expressed by non-U.S. reinsurers with U.S. affiliates
    - POE reinsurer definition amended
    - Physical U.S. presence is allowed, can not be a "U.S. Underwriting or Claims Paying Office", as defined within the proposal
  - Pure vs. mixed reinsurer
    - Previous version restricted framework to "Pure" Reinsurer - no more than 5% direct business
    - Primary concern is with a foreign jurisdiction's solvency proceeding - liquidation preference for a ceding insurer in the event of POE reinsurer insolvency
    - Latest revision removes the limitation – adds consideration of foreign jurisdiction's insolvency proceedings as a factor to be considered in rating evaluations for POE reinsurers

Other Key Issues

- Primary issues – continued
  - Mandatory contract clauses
    - Concern over addition of “new” mandatory contract clauses
    - Task Force noted the Credit for Reinsurance Clause is new as a result of this framework
    - All other clauses listed are required elsewhere under current reinsurance regulations
    - Section is under consideration, and may be modified to refer to “clauses required by existing laws”
  - POE reinsurer reporting requirements
    - Concern expressed over substance and extent of POE reinsurer reporting requirements
    - Content retained, frequency modified from quarterly to annual basis
    - 10-day notification required for regulatory actions, changes in domiciliary license or change in an NRSRO rating, along with description

Other Key Issues

- Primary issues and concerns - continued
  - Diversification requirements for ceding insurers
    - Concern over “new” diversification authority for domiciliary states
    - Task Force emphasized that the diversification requirements are discretionary, not mandatory, applied on a case by case basis, and exist under current reinsurance regulations
  - Reliance on rating agencies (NRSRO’s)
    - Industry expressed significant concern on the previous revision’s reliance on rating agencies in collateral requirement determination
    - Task Force emphasized that NRSRO ratings are important, but are only one factor in rating evaluation
    - NRSRO rating matrix does not determine final rating, but establishes a maximum allowable rating and a reasonable starting point
    - Supervisory rating matrix and relevant language was revised to reduce emphasis on NRSRO ratings

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Other Key Issues

- Primary issues - continued
  - Disparate treatment between U.S. and non-U.S. reinsurers
    - Collateral differences on the basis of U.S. vs. non-U.S., with otherwise equivalent ratings, were removed from the proposal
    - U.S. companies can choose to continue operating under the existing reinsurance laws
  - Catastrophe recoverable collateral deferral
    - Ceding companies expressed concern over this deferral period
    - Task Force determined the deferral is reasonable and prudent
    - Most CAT payments occur within the first year of the date of loss
    - Eases pressure on a reinsurer's capital and liquidity
    - Payment issues are typically reported very quickly, appropriate action can follow
    - Catastrophe is defined as "recognized by the home state or POE supervisor."

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Other Key Issues

- Primary issues - continued
  - Affiliated transactions
    - Potential collateral reductions under this proposal are substantial enough that further adjustment for affiliated transactions was not warranted.
  - Run-off scenarios
    - No specific treatment needed, as issue will be addressed by supervisory rating downgrade upon a reinsurer entering into run-off
    - Concerns over jurisdictional run-off provisions can be addressed during RSRD supervisory recognition process (recognition with restrictions, maximum ratings, factors)

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Other Key Issues

- Primary issues - continued
  - Implementation
    - Federal enabling legislation approach recommended
    - Preserve state-based regulation of reinsurance on a cross-border basis
    - Promote uniformity of cross-border reinsurance regulation throughout the NAIC member jurisdictions
  - Mutual recognition
    - Constitutional concerns regarding mutual recognition will be addressed through a proper federal enabling legislation approach to implementation
  - Comprehensive Life industry reinsurance reform
    - Life industry representatives voiced concern with modification of collateral requirements without accompanying substantial revision of life company reserving standards and life industry reinsurance reform
    - Task Force notes that it will raise the concerns that have been expressed with other NAIC groups, and will consider the specific reinsurance issues following the completion of this proposal

Other Key Issues

- Remaining details
  - Adoption
  - Implementation
  - RSRD
    - Uniform minimum standards and certification mechanism for states to qualify as home state and POE supervisors
    - Non-U.S. supervisory evaluation process – initial and ongoing
    - Development of Purposes & Procedures Manual, and relevant sample agreements

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IAIS REINSURANCE SUBCOMMITTE

- Supervisory Guidance Paper on Reinsurance Mutual Recognition
- Supervisory Standard on the Evaluation of Ceded Reinsurance
- Supervisory Standard on Finite Reinsurance
- A meeting of members and observers of the Reinsurance Transparency Group.

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IAIS REINSURANCE SUBCOMMITTE

- Reinsurance Mutual Recognition Subgroup and the Reinsurance and Other Forms of Risk Transfer Subcommittee aims to:

1. Facilitate reinsurance by developing an efficient and effective supervisory framework.
2. Host supervisors mutually recognize the quality of regulation and supervision of other jurisdictions.
3. Bi-lateral or multi-lateral agreements.
4. Not intended to abrogate the home supervisor from responsibility.
5. Identify minimum principles for coordination or reinsurance regulation.
6. Cooperation and trust further strengthened.

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IAIS REINSURANCE SUBCOMMITTE

- Mutual Recognition Subgroup – Two tracks of work

  First track has been mostly achieved. Development of minimum principles for mutual recognition between home and host supervisors.

  Second track will continue to need development in reviewing IAIS principles, standards and guidance papers to determine whether additional guidance will be required to act as a basis for a functioning system of mutual recognition.

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