Regulating "Collateral Damage": New York Finalizes Changes To Reg 20

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With the promulgation in late November 2010 of the Tenth Amendment to 11 NYCRR 125 (Regulation 20), New York became the second U.S. state (following Florida) to enact a ratings-based framework allowing ceding insurers to take full statutory financial statement credit for reinsurance ceded to certain unauthorized reinsurers without the reinsurers posting commensurate collateral. The amended regulation becomes effective January 1, 2011.

Some industry participants, especially those outside the United States, consider this development overdue implementation of fairer reinsurance collateral requirements essential for an efficient global reinsurance market. On the other side of the longstanding debate, detractors continue to question the prudence of "less regulation" by way of reduced reinsurance collateral requirements at any time, and especially now given the vicissitudes of the economy generally, and the financial sector in particular. Whether one such position proves correct remains to be seen. In any event, a prominent U.S. insurance regulatory authority has deemed this course appropriate.

This paper will discuss some of the practical implications of New York's regulation. Informative in this regard are responses of the New York Insurance Department (the "Department") to comments it received after floating the changes in proposed form earlier in 2010. These responses indicate that the Department by no means views the changes as diminishment of its regulation of the insurance entities and reinsurance activities within its purview.[1]

How Will the Ratings-Based Framework Operate?

Under the modified regulation, the unauthorized reinsurer (which could be an alien reinsurer or one domiciled in a U.S. jurisdiction other than New York) must secure one of five possible ratings from the New York Superintendent of Insurance (the "Superintendent"). That rating will determine the *minimum* level of collateral required for a ceding company to take full credit for a cession to that reinsurer, as follows:

Rating	Minimum Collateral
Secure-1	0 percent
Secure-2	10 percent
Secure-3	20 percent
Secure-4	75 percent
Vulnerable-5	100 percent

[1] Unless otherwise indicated, quoted language appearing herein is from the Department's responses to comments.

As a result, for example, an insurer ceding to an unauthorized reinsurer assigned the highest rating (Secure-1) could take full reinsurance credit without the reinsurer having to post any collateral. In the case of a Secure-2 rating, the reinsurer would have to post collateral equal to at least 10% of the credit (i.e., a reduction in collateral of as much as 90% is allowed). Falling below a Secure-3 rating severely crimps the potential for collateral relief. A reinsurer rated Secure-4 would have to post at least 75% collateral, as compared to 20% collateral required under a Secure-3 rating. A Vulnerable-5 rating would result in no collateral reduction.

The ratings-based framework will be available for reinsurance contracts entered into or renewed on or after January 1, 2011. It will apply to reinsurance of property and casualty risks, as well as to reinsurance involving risks of life, annuity, and accident and health.[2]

The Department has stated that the reinsurer ratings will be publicly available.

How Will the Reinsurer's Rating Be Determined?

The unauthorized reinsurer must apply to the Superintendent for a reinsurer rating using prescribed forms, accompanied by a $10,000 application fee. The highest potential rating that the Superintendent may assign to the reinsurer is determined by the reinsurer's financial strength ratings from recognized rating agencies, in accordance with the table below.

Highest Possible NY Rating	Best	S&P	Moody's	Fitch
Secure-1	A++	AAA	Aaa	AAA
Secure-2	A+	AA+, AA, AA-	Aa1, Aa2, Aa3	AA+, AA, AA-
Secure-3	A, A-	A+, A, A-	A1, A2, A3	A+, A, A-
Secure-4	B++, B+	BBB+, BBB, BBB-	Baa1, Baa2, Baa3	BBB+, BBB, BBB-
Vulnerable-5	B, B-, C++, C+, C, C-, D, E, F	BB+, BB, BB-,B+, B, B-, CCC, CC, C, D, R, NR	Ba1, Ba2, Ba3, B1, B2, B3, Caa, Ca, C	BB+, BB, BB-, B+, B, B-, CCC+, CCC, CCC-, DD

The reinsurer must maintain, on a stand-alone basis, an interactive financial strength rating from at least two recognized rating agencies. The lowest such financial strength rating will determine the highest potential NY reinsurer rating. This means that to secure the substantial collateral relief available with a rating of Secure-3 or higher, the reinsurer must have financial strength ratings no lower than A-/A3 from at least two recognized rating agencies. A reinsurer with a

[2] The operative provisions of the ratings-based framework are set out in Section 125.4(h). Section 125.4 applies to property and casualty reinsurance from unauthorized insurers. Section 125.5, which covers reinsurance involving the risks of life, annuity, and accident and health, incorporates the Section 125.4(h) framework by reference.

rating no higher than B from Best, BB+ from S&P or Fitch, or Ba1 from Moody's could not qualify for reduced collateral.

Group or parent ratings will not enter the equation here. As the Department explained, "[t]he amendment requires that the rating agency financial strength rating be tied to an individual company. . . . [T]o allow group rating would, in some cases, result in an inaccurate evaluation of the financial strength of the individual company, without the parent assuming any legal obligation for the reinsurance payable by the company."

Absent the required financial strength ratings, a reinsurer cannot qualify for collateral reduction. Financial strength ratings, however, will not exclusively determine whether, and how much, collateral reduction will be approved for a given reinsurer. The regulation authorizes the Superintendent to consider a number of other factors, delineated in Section 125.4(h)(4), each of which could cause the collateral relief to be curtailed, if not eliminated entirely.

Will Agency Ratings Control?

Some have questioned the merits of a regulation relying on financial strength ratings when recent events have underscored the shortcomings of the financial credit rating system. The Department has emphasized that agency ratings alone will not carry the day; "[f]inancial strength ratings establish the maximum collateral relief allowable[;] however, the Superintendent has authority to lower the amount of relief based on many factors." Consequently, "the review of the factors stated in 125.4(h)(4) mitigates against over-reliance on the credit rating agencies."

Under Section 125.4(h)(4), the Superintendent may consider:

> (i) the reinsurer's compliance with reinsurance contractual terms and obligations (including mandatory contractual clauses);
>
> (ii) the reinsurer's business practices in dealing with cedents;
>
> (iii) a report by the reinsurer similar to the most recent applicable NAIC Filing Blank, either Schedule F or Schedule S;
>
> (iv) the reinsurer's reputation for prompt payment of claims under reinsurance agreements, including the proportion of obligations more than 90 days past due or in dispute, with particular attention to reinsurance payables to insurers that are under administrative supervision or in receivership;
>
> (v) regulatory actions against the reinsurer;
>
> (vi) the reinsurer's annual financial statements and opinion thereon of an independent certified public accountant, regulatory filings, and actuarial opinions;

(vii) the liquidation preference of obligations to a cedent in the reinsurer's domiciliary jurisdiction in the context of an insolvency proceeding;

(viii) participation by the reinsurer in any solvent scheme of arrangement, or similar procedure that involves U.S. cedents;[3]

(ix) any other information deemed relevant by the Superintendent.

Much of the information relevant to these factors apparently will come from the reinsurer itself, through the initial application, an annual renewal process, and other reporting requirements imposed on the reinsurer (see next section). How the Department will supplement such information through other sources remains to be determined as implementation of the regulation progresses.

Actual implementation of the regulation similarly will inform as to how the Department intends to exercise its discretion to limit or deny a reduction in collateral otherwise supported by agency ratings, including what specific facts and circumstances it will deem relevant to each factor and the weight given thereto. Notably in this regard, claims paying history received particular attention in the Department's responses to comments. The Department explained that it "takes claims paying history into account when assigning a financial strength rating." It also intends to "work with industry to identify 'slow paying' reinsurers." Again, how the Department will develop such information through sources other than the reinsurers has not been specified. In any event, it appears that claims paying history will be placed under a spotlight.

What Other Requirements Will Apply to Rated Reinsurers?

In addition to the requirements summarized above, the unauthorized reinsurer must:

- meet the standards of solvency, including standards for capital adequacy, established by its domiciliary regulator;
- be authorized in its domiciliary jurisdiction to assume the kind of reinsurance ceded by the ceding insurer;
- maintain policyholders' surplus (or equivalent) in excess of $250,000,000, calculated on the basis of U.S. GAAP or U.S. statutory accounting principles;
- notify the Superintendent within 30 days in the event of any change in its domiciliary license status or rating status;

[3] With regard to item (viii), the regulation provides that "[e]ntrance into such an arrangement or procedure that involves one or more U.S. cedents will result in an assignment of a Vulnerable-5 rating." As a result, a reinsurer's participation in a solvent scheme of arrangement involving a U.S. cedent will prevent eligibility for any collateral reduction whatsoever under the ratings-based alternative.

- file with the Superintendent, on an **annual** **basis**:

  - audited financial statements covering the last three years and actuarial opinions filed with the domiciliary regulator;

  - a report in form similar to Schedule F or Schedule S to the NAIC Annual Filing Blank;

  - a list of all disputed or overdue recoverables (presumably from the reinsurer to its cedents);

  - certification of the reinsurer's good standing from the domiciliary regulator, as well as that regulator's certification that it will provide financial and operational information to the Superintendent;

  - a renewal application for the reinsurer rating and $5,000 fee.

Furthermore, if the reinsurer is domiciled outside the United States, the Superintendent and the domiciliary regulator must be parties to a memorandum of understanding that addresses matters the Superintendent deems relevant for proper oversight of reinsurance transactions. In addition, the domiciliary jurisdiction of the unauthorized alien reinsurer must allow U.S. reinsurers access to the market of the domiciliary jurisdiction on terms and conditions that are at least as favorable as those provided by the laws of New York for unauthorized alien reinsurers.

What Happens If the Reinsurer's Circumstances Change?

As noted above, the reinsurer must notify the Superintendent within 30 days in the event of a change in the status of the reinsurer's agency ratings or domiciliary license. Material negative developments will presumably trigger a reduction in, or withdrawal of, a reinsurer's rating. In addition, the reinsurer's rating will be revisited at least annually in connection with the renewal application and other information required to be filed by the reinsurer. If the reinsurer's rating is or falls below that required for the amount of credit in place, the existing credit to the ceding insurer must be adjusted accordingly unless the reduced credit is funded by collateral or funds withheld pursuant to section 125.6(b). However, the Superintendent may, in the interest of ensuring market stability and the solvency of the ceding insurer, upon request by the ceding insurer, authorize it to continue to take credit for the reinsurance recoverable, or part thereof, for a specified period, unless the reinsurance recoverable is deemed uncollectible.

The ceding company also must actively assess the outlook for collection of reinsurance recoverables from the rated reinsurer. The regulation requires that "[i]f the ceding insurer's experience in collecting recoverables from any assuming insurer indicates that the credit to the ceding insurer should be lower, the ceding insurer shall adjust the credit accordingly." Elaborating on this provision, the Department stated that the "regulation expects ceding insurers to account for uncollectible net-of-collateral receivables by reducing the credit taken for reinsurance."

Does the Regulation Dictate Provisions of Reinsurance Agreements?

Yes. A ceding insurer may not take reinsurance credit pursuant to the ratings-based framework unless the reinsurance contract with the unauthorized reinsurer:

(a) includes an insolvency clause as provided for in NY Insurance Law section 1308(a)(2)(A);

(b) requires the unauthorized reinsurer to designate a person in New York or the state of domicile of the ceding insurer as its true and lawful agent for service of process;

(c) provides that if, pursuant to Article 74 of the Insurance Law or the equivalent law of another state, an order of rehabilitation, liquidation or conservation against the ceding insurer is entered, the unauthorized reinsurer (if alien) shall, within 30 days of entry of the order, fund the entire amount for which the ceding insurer has taken credit for reinsurance recoverable from the unauthorized alien reinsurer; and

(d) includes the following provisions:

> Any dispute, suit, action or proceeding under the contract, or any dispute, suit, action or proceeding arising out of, directly, indirectly, or incidentally, or related to the contract or of the transactions and actions arising from performance of the contract are to be subject to the jurisdiction, and resolved in the courts, of the United States or any state thereof, and that the assuming insurer submits to the personal jurisdiction of such court, complies with the requirements necessary to give that court jurisdiction, abides by the final decision of that court or of an appellate court in the event of an appeal, and consents to any effort to enforce the final decision of the court in the home jurisdiction of the alien assuming insurer, including the granting of full faith and credit or comity in the home jurisdiction of the assuming insurer or any other jurisdiction where the assuming insurer is subject to jurisdiction. This provision does not override an agreement between the ceding insurer and the unauthorized alien assuming insurer to arbitrate, in accordance with the laws of the U.S. or any state thereof.

- and -

> Any dispute, suit, action or proceeding under the contract, or any dispute, suit, action or proceeding arising out of, directly, indirectly, or incidentally, or related to the contract or of the transactions and actions arising from performance of the contract are to be governed by and construed in accordance with [choose one option] the laws of the State of

> New York or the laws of the state in which the ceding insurer is domiciled or the laws of any state chosen by ceding insurer. This provision does not override an agreement between the ceding insurer and the unauthorized alien assuming insurer to arbitrate, in accordance with the laws of the U.S. or any state thereof.

Why the Change to Add a Ratings-Based Alternative?

According to the Department, the regulation "is intended to level the playing field for all reinsurers, based on their financial strength (among other things)." Noting that most non-U.S. jurisdictions do not require non-domestic reinsurers to post collateral for ceding insurers to take credit, the Department stated that New York will be "in line with global insurance markets and worldwide accounting standards governing reinsurance contracts." As for bottom-line impact, the Department maintains that the changes "will reduce transactional costs and increase reinsurance capacity."

Thus, New York appears to be of the view that relaxed collateral requirements, resulting in reduced capital costs for reinsurers, will invite financially strong reinsurers into the New York market. Notably in this regard, Florida to date has authorized six reinsurers under its framework for reduced collateral applicable to property and casualty reinsurers, suggesting successful attraction of additional capacity to a market in need of property/casualty cover. On a macro level, expanded capacity (*i.e.*, more competition among reinsurers) would generally be expected to reduce reinsurance premium costs for cedents. At a micro level, reduced costs for any one reinsurer arguably would provide opportunity for a cedent to negotiate a better price. How this may play out in the context of "hard" or "soft" reinsurance markets remains to be seen.

What Happens to the "Old" Way?

The ratings-based framework under the modified Reg 20 constitutes an additional, alternative means for ceding companies to obtain reinsurance credit for transactions with unauthorized reinsurers. Credit would still be available for transactions that meet the already existing (and continuing) provisions of the regulation relating to unauthorized reinsurers, including the posting of collateral in the form of letters of credit or other qualifying assets and/or funds withheld arrangements.

What Ceding Companies Will Be Impacted?

New Section 125.1 provides:

> This Part shall apply to insurers authorized to do business in this State, *provided that where the state of domicile of a foreign ceding insurer is an NAIC-accredited state, or has financial solvency requirements substantially similar to the requirements necessary for NAIC accreditation, and recognizes credit for*

reinsurance for the insurer's ceded risk, then the foreign ceding insurer may take credit for the reinsurance.

New York previously has applied its credit for reinsurance regulation "extraterritorially" to all NY-authorized insurers, regardless of where domiciled. The proviso (italicized above) in Section 125.1 departs from this historical approach. This departure is consistent with Section 531(a) of the Nonadmitted and Reinsurance Reform Act of 2010, and would be required in any event when the Act becomes effective on July 21, 2011.[4] Consequently, New York will have to allow credit for reinsurance taken by a NY-authorized insurer domiciled elsewhere in the United States whenever the insurer's domiciliary state allows such credit, regardless of whether the domiciliary state's rules align with New York's. In practical effect, New York's modified Regulation 20 will dictate the extent to which *New York-domiciled ceding companies* may take reinsurance credit, whether from transactions involving authorized or accredited reinsurers, or unauthorized reinsurers.

Although recognizing the Federal mandate relating to recognition of reinsurance credit, New York appears to be aiming to impose certain principles of prudent reinsurance credit risk management on all NY-authorized insurers, without exception.

What Are the Principles of Prudent Reinsurance Credit Risk Management?

New Section 125.3(a) requires that an "authorized insurer, hereinafter referred to as a 'ceding insurer,' shall at all times act with financial prudence when entering into any reinsurance arrangement," and identifies eight factors that the ceding insurer must consider. Section 125.3(b) goes on to impose certain reporting requirements on such ceding insurers when certain thresholds for reinsurance recoverables or cessions are hit. A ceding insurer must notify the Superintendent within 30 days after a reinsurance recoverable from any single assuming insurer, or group of affiliated assuming insurers, exceeds 50 percent of the ceding insurer's last reported surplus to policyholders. A ceding insurer similarly must notify the Superintendent within 30 days after ceding an amount exceeding 20 percent of its total gross written premium in the prior calendar year to any single assuming insurer, or group of affiliated assuming insurers. In each case, the required notification must demonstrate that the ceding insurer is safely managing the exposure.

Will Ceding Companies Be More at Risk?

Some critics of the ratings-based framework maintain that the only way to protect cedents from reinsurer insolvency is to require full collateral. It is axiomatic that a reduction in collateral

[4] The Nonadmitted and Reinsurance Reform Act of 2010 is a subtitle of the Dodd-Frank Wall Street Reform And Consumer Protection Act signed into law by President Obama on July 21, 2010. Section 531(a) reads: "If the State of domicile of a ceding insurer is an NAIC-accredited State, or has financial solvency requirements substantially similar to the requirements necessary for NAIC accreditation, and recognizes credit for reinsurance for the insurer's ceded risk, then no other State may deny such credit for reinsurance."

increases risk to the cedent, assuming, of course, the availability of the same reinsurance cover *with* collateral. On this point the Department "believes reinsurers that qualify for reduced collateral will be in a position to meet their obligations by virtue of their financial strength coupled with [Department] review." Furthermore, "[n]othing in the regulation precludes the ceding insurer from requiring collateral from their non-U.S. licensed assuming reinsurers as part of their reinsurance negotiations when they feel such collateral would be prudent."

The Department's comments indicate an expectation that a ceding insurer will ultimately determine whether it can live with reduced collateral as a risk matter. It will balance the costs and benefits of doing business with a particular reinsurer under a given collateral arrangement (including no, or less than full, collateral, where permitted). As a result, the reinsurance procurement process may involve more permutations when highly-rated reinsurers are involved, such as requests for pricing with full collateral and no/reduced collateral, or even a spectrum of collateral between the minimum allowed under the regulation and full collateral. Perhaps ceding companies will engage in even more rigorous internal "rating" of the strength and payment history of prospective reinsurers. Indeed, as noted above, the Department has indicated that it intends to look well beyond a reinsurer's financial strength ratings when determining whether reduced collateral is appropriate.

Where Will This Lead?

Some industry participants assert that while initiatives like New York's represent positive steps, the individual state approach, as opposed to a uniform and global template, continues to disservice the reinsurance market. In response, New York emphasized repeatedly that its regulation is consistent with the NAIC's approach, as expressed in the NAIC's 2008 Reinsurance Regulatory Modernization Framework Proposal and, more recently, in the Reinsurance Collateral Reduction & Accreditation Recommendations, adopted by the NAIC's Reinsurance Task Force in October 2010.

Implicit here appears to be the expectation that time will lead to a relatively uniform adoption by all states within the NAIC framework. Although other states reportedly are considering comparable collateral reduction reforms, one might argue that broad-based adoption in the near term is optimistic, especially given the current environment, where any changes in financial services regulation that could be spun as a concession or "less" regulation would leave the regulator vulnerable to criticism. Moreover, absent a modified NAIC Credit for Reinsurance Model Law incorporating a ratings-based framework and adopted uniformly by all states, material state-by-state variation could result.[5] In the end, as much as anything else, market realities may dictate the pace at which more states adopt similar reforms. If moves like those in New York and Florida prove to increase capacity and decrease costs of reinsurance for domestic

[5] For example, Florida's current regulation applies only to property and casualty reinsurance, while New York will apply its ratings-based framework to reinsurance of risks relating to life, annuities, and accident and health, as well as property and casualty.

cedents, other states may be forced to follow in order to keep “level” yet another “playing field” – that on which their own domestic insurers compete with insurers domiciled in other states.

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