# Leveling the Playing Field: NAIC Financial Condition (E) Committee Adopts Revisions to Credit for Reinsurance Models

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The NAIC's Financial Condition (E) Committee has adopted revisions to the NAIC Credit for Reinsurance Model Law (#785) and Credit for Reinsurance Model Regulation (#786). At the heart of the revisions is the addition of a ratings-based framework allowing a ceding insurer to take full statutory reinsurance credit for reinsurance ceded to a "certified reinsurer," without the reinsurer posting full collateral as security for its payment obligations. Adopted on September 19, 2011, the revisions track the July 26 drafts exposed by the Reinsurance (E) Task Force, with certain additional amendments to the Model Regulation made by both the Task Force and the Committee during their respective meetings on September 19.[1] The timeline for final consideration and potential adoption of these revisions by the NAIC Executive (EX) Committee and Plenary had not yet been published as of the date of this article.

After briefly summarizing the status quo with regard to U.S. reinsurance collateral requirements, this article will discuss key elements of the new "certified reinsurer" provisions under the revised Models and potential implications thereof. It will then address how the revised Models accord with the NAIC's efforts (both historical and ongoing) to modernize reinsurance regulation in the United States, and how the revisions align with Dodd-Frank's Nonadmitted and Reinsurance Reform Act and the initiatives of certain states (most notably New York and Florida) with respect to reinsurance collateral requirements.

## THE STATUS QUO

Under the Credit for Reinsurance Model Law and Model Regulation in their current forms (i.e., without the revisions recently adopted by the Committee), a U.S.-domiciled insurer generally may take credit (as an asset or reduction from liability) for reinsurance ceded to a reinsurer that is (1) licensed to transact insurance or reinsurance, or is accredited as a reinsurer, in the ceding company's state of domicile, or (2) domiciled in, or has entered as a U.S. branch of

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[1] The July 26 exposure drafts can be found at http://www.naic.org/committees_e_reinsurance.htm. The Meeting Summary Report for the Reinsurance (E) Task Force's September 19 meeting can be found at http://www.naic.org/meetings1108/summary_e_reinsurance.htm. The Meeting Summary Report for the Financial Condition (E) Committee's September 19 meeting can be found at http://www.naic.org/meetings1108/summary_e_ecmte.htm.

an alien insurer through, a state with credit for reinsurance standards substantially similar to those of the ceding company's domiciliary jurisdiction. If a U.S.-domiciled insurer cedes to a reinsurer that does not fall into one of these two categories, with certain limited exceptions reinsurance credit is generally allowed only if and to the extent the reinsurer posts collateral as security for its payment obligations under the reinsurance contract. The reinsurer must provide such collateral by way of funds held by or on behalf of the ceding company, including funds held in trust for the ceding company's benefit. The collateral must be in the form of cash, securities listed by the Securities Valuation Office of the NAIC and qualifying as admitted assets, or clean, irrevocable, unconditional letters of credit.

These collateral requirements have long been a source of contention in the industry, with many participants based outside the United States arguing that the rules ignore the most essential consideration – the financial strength of the reinsurer, regardless of domicile – and, as a result, unfairly prejudice non-U.S. reinsurers competing for business in the United States. As discussed in more detail later in this article, proposals to level this playing field have been in the works for several years at the NAIC, and a few states already have enacted reforms to address this perceived lack of fairness in collateral requirements with the aim of promoting more efficient global reinsurance markets.

## THE REVISED MODELS – STATE CERTIFICATION AND RATING OF REINSURERS

### A Six-Tier Rating Scale

Under the revisions adopted by the Financial Condition (E) Committee, a reinsurer may apply for certification by a state's insurance regulator, with that state assigning the reinsurer one of six possible ratings upon certification. The assigned rating determines the *minimum* level of collateral required to be posted by the certified reinsurer for the ceding insurer to take full reinsurance credit, as follows:

| Rating | Collateral |
|---|---|
| **Secure-1:** | **0%** collateral required |
| **Secure-2:** | **10%** collateral required |
| **Secure-3:** | **20%** collateral required |
| **Secure-4:** | **50%** collateral required |
| **Secure-5:** | **75%** collateral required |
| **Vulnerable-6:** | **100%** collateral required |

Notably, this scale includes a tier at the Secure-4 rating level requiring 50% collateral. Earlier Reinsurance Task Force proposals in connection with the NAIC's 2008 Reinsurance Regulatory Modernization Framework, as well as New York's recently amended Regulation 20 and

Florida's Rule 69O-144.007, included five tiers, with required collateral jumping from 20% for a Secure-3 rating to 75% for Secure-4.

Threshold Requirements

To be eligible for state certification under the revised Models, a reinsurer[2] must (in addition to any other requirements the commissioner may impose):

- be domiciled and licensed in a qualified jurisdiction;
- maintain minimum capital and surplus of $250,000,000;
- maintain financial strength ratings from at least two approved rating agencies;
- agree to submit to the state's jurisdiction and appoint the commissioner as agent for service of process in the state; and
- agree to prescribed information filing requirements.

The revised Models contemplate that a state will establish and publish a list of the qualified jurisdictions in which reinsurers may be domiciled and licensed to be eligible for consideration for state certification. U.S. jurisdictions that meet the requirements for NAIC accreditation are recognized as qualified jurisdictions. In determining whether a reinsurer's domicile is a qualified jurisdiction, a state may independently assess non-U.S. jurisdictions in accordance with the Model Regulation's standards or defer to a list published by the NAIC. Principal considerations in the evaluation of a non-U.S. jurisdiction as a qualified jurisdiction include the applicable reinsurance supervisory system, the extent of reciprocal recognition afforded U.S. reinsurers, and agreements to share information and cooperate with a state's commissioner with respect to all certified reinsurers domiciled in the non-U.S. jurisdiction.[3] The Model Act revisions prohibit a jurisdiction from being recognized as a qualified jurisdiction if the commissioner determines that the jurisdiction does not adequately and promptly enforce final U.S. judgments and arbitration awards.

If a reinsurer receives certification from an NAIC accredited state, another state may defer to that certification and the attendant state rating. Such deference is not required, however, which theoretically could lead to a reinsurer operating in the United States with different ratings – and hence different collateral requirements – for various states. Consequently, unless states routinely and uniformly defer to a previous certification from another state, a certified reinsurer operating with varying state ratings could find itself obligated to post different percentages of

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[2] The revised Models make provision in their requirements for an association including incorporated and individual unincorporated underwriters to qualify for certification as a reinsurer.

[3] Thus, the revised Models encourage the expansion of the cooperation agreements that have been effected between various states and foreign insurance regulators. See, for example, the Connecticut Insurance Department's recent announcement of its cooperation agreement with Switzerland at http://www.ct.gov/cid/cwp/view.asp?Q=487308&A=1269.

collateral under different reinsurance agreements and programs. Indeed, even a single program involving multiple ceding entities (for example, a group of affiliated insurers domiciled in different states ceding to one certified reinsurer) could produce curious results. With such a program, depending on the reinsurer's ratings from the ceding insurers' domiciliary states, the reinsurer conceivably could be required to post different percentages of collateral for each ceding insurer.

Determining a Reinsurer's State Rating

The Model Regulation revisions call out specific factors that may be considered in determining a reinsurer's certification, in addition to any other information the commissioner may deem relevant. The financial strength ratings issued by approved rating agencies will play a major role. The lowest financial strength rating from an approved agency will establish the maximum possible state rating for the certified reinsurer, consistent with the following table.[4]

| 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 | A1, A2 | A+, A |
| Secure-4 | A- | A- | A3 | A- |
| Secure-5 | B++, B+ | BBB+, BBB, BBB- | Baa1, Baa2, Baa3 | BBB+, BBB, BBB- |
| Vulnerable-6 | B, B-, C++, C+, C, C-, D, E, F | BB+, BB, BB-, B+, B, B-, CCC, CC, C, D, R | Ba1, Ba2, Ba3, B1, B2, B3, Caa, Ca, C | BB+, BB, BB-, B+, B, B-, CCC+, CC, CCC-, DD |

Thus, for example, a reinsurer with a rating of A+ from Best and A1 from Moody's would be eligible for no higher than a Secure-3 state rating.

Other specified factors in the certification assessment include:

- The reinsurer's record of compliance with reinsurance contract obligations and other business practices in dealing with ceding insurers.
- The reinsurer's most recent annual information filing (for a U.S.-domiciled reinsurer, Schedule F or Schedule S to its Annual Statement; for a non-U.S. reinsurer, the revisions contemplate forms CR-F and CR-S, to be developed).
- The reinsurer's reputation for prompt payment. Under the Model Regulation revisions, the commissioner must increase the minimum required collateral by at least

[4] The financial strength ratings may not be based solely on publicly available information; interactive communications between the reinsurer and the rating agencies must support the ratings.

one rating level if (a) more than 15% of the reinsurer's ceding insurance clients have undisputed overdue reinsurance recoverables on paid losses of 90 days or more and which exceed $100,000 for each cedent, or (b) the aggregate amount of undisputed reinsurance recoverables on paid losses overdue by 90 days or more exceeds $50,000,000.

- Regulatory actions against the reinsurer.
- Financial statements and related auditors' reports, regulatory filings, and actuarial opinions.
- Liquidation priorities of obligations to ceding insurers in the reinsurer's domiciliary jurisdiction.
- The reinsurer's participation in any solvent scheme of arrangement or similar procedure involving U.S. ceding insurers. This factor was a point of debate as the revisions took form, with some taking the position that a reinsurer's participation in a solvent scheme of arrangement should block certification outright. Although such position did not prevail in the end (assuming no further revisions on this issue), nothing would appear to prevent a state from assigning significant weight to this factor to effectively reach the same result whenever a problematic solvent scheme is present.

The revisions to the Model Regulation allow for public input on applications for certification. The commissioner must post notice of each application for certification received, with instructions for public comment thereon. Final action on the application may not occur until at least 30 days after the posting.

Additional Elements

Other key elements of the certified reinsurer revisions include:

- Affiliated reinsurance transactions receive the same opportunity for reduced collateral.
- For certain lines of business, a one-year deferral period is allowed for posting security for catastrophe recoverables.
- Upon the entry of an order of rehabilitation, liquidation, or conservation against the ceding insurer, a commissioner must require the reinsurer to post 100% collateral for the benefit of the ceding insurer or its estate.
- The parties to a reinsurance agreement may agree to stricter collateral requirements.
- The new provisions apply to reinsurance contracts entered into or renewed on or after the effective date of the reinsurer's certification. However, any contract entered into before the effective date of the certification that is amended after the effective date of certification, or any new reinsurance contract, covering any risk for which collateral

was provided previously, is subject to the new provisions only with respect to losses incurred and reserves reported from and after the effective date of the amendment or new contract.

The new certified reinsurer provisions address the longstanding complaint of non-U.S. reinsurers that collateral requirements in the United States make for an uneven playing field, but they do not preclude any of the previously established means for reinsurance credit authorized under the Models. Thus, for example, an insurer ceding to an alien reinsurer that does not qualify for state certification may take full reinsurance credit if the reinsurer posts full collateral in the forms and through the methods described above under "The Status Quo."

## THE BIGGER PICTURE

In an effort to address the reinsurance collateral requirements issue specifically, and more generally the perceived need to modernize reinsurance regulation to better align with the realities of a global market, the NAIC in late 2008 adopted its Reinsurance Regulatory Modernization Framework Proposal. The Framework Proposal sought to establish uniform, single-jurisdiction U.S. regulation of reinsurers operating in the United States. The Framework Proposal also eliminated the dichotomy between U.S. and non-U.S. reinsurers as a controlling factor in determining collateral requirements by introducing a ratings-based process for determining collateral requirements, much of which is found in the recent revisions to the Models. One notable difference between the Framework Proposal and the revisions to the Models, however, is that the former called for a reinsurer's U.S. supervising jurisdiction to assign the reinsurer's rating. Under that approach, a reinsurer would have had to apply only once for a single rating that would apply to all of its reinsurance undertakings with U.S. ceding insurers. Under the revisions to the Models, the reinsurer will need to apply for a rating in each state in which a prospective reinsured is domiciled, a potentially time consuming and burdensome requirement.

The NAIC proposed federal legislation as the means to implement the Framework Proposal, but was unable to find a sponsor for the legislation as the global financial crisis of 2008-2009 overtook the attention of legislators and regulators. Although the insurance sector was not perceived as a contributor to global financial market woes, the Dodd-Frank Act included the Nonadmitted and Reinsurance Reform Act ("NRRA"), which took effect on July 21, 2011. The NRRA mandates (inter alia) that the laws of the domiciliary jurisdiction of a U.S. ceding insurer will control the determination of reinsurance credit taken by that insurer. As a result, no state may deny reinsurance credit for a U.S. ceding insurer if and to the extent the insurer's domiciliary state has authorized credit. In addition, the NRRA establishes the domiciliary jurisdiction of a U.S. reinsurer as the sole regulator of the reinsurer's solvency.

The Reinsurance (E) Task Force's adoption of the revisions to the Models included a "Preface to Credit for Reinsurance Models."[5] The Preface indicates that the NAIC considers the revisions to be consistent with the NRRA's preemption of extraterritorial application of state credit for reinsurance law, as well as the discretion allowed domiciliary states to reform reinsurance collateral requirements on an individual basis. The Preface also asserts that the NRRA does not prohibit the states from acting together, through the NAIC, to achieve other reinsurance modernization goals. Accordingly, the NAIC views the revised Models as part of a larger, ongoing effort to modernize U.S. reinsurance regulation, and it will continue efforts to implement other aspects of the 2008 Reinsurance Regulatory Modernization Framework Proposal. With regard to collateral requirements specifically, it will consider forming a new group to provide review of reinsurance collateral reduction applications and related assistance to the states and will continue to work on requirements for NAIC review and approval of qualified jurisdictions. It also intends to reexamine the required collateral amounts within two years after the effective date of the revisions to the Models.

Not all states have remained idle as the NAIC has worked through the reinsurance collateral issues. A few states have already enacted reforms based on a rating system for reinsurers similar (but not identical) to that found in the revisions to the NAIC Models. Florida was first out of the starting gate, adopting Rule 69O-144.007 for property and casualty reinsurance, effective October 29, 2008. New York modified its Regulation 20, effective January 1, 2011. (A Jorden Burt *Special Focus* article on this development can be found at http://02ec4c5.netsolhost.com/blog/wp-content/uploads/2009/11/Special-Focus-NY-reinsurance-credit-regulation-12.13.10.pdf.) New Jersey and Indiana also have enacted reinsurance collateral reforms, but New Jersey has not yet implemented a specific rating scale, leaving the extent to which collateral may be reduced in a given case to the commissioner's discretion.

## CONCLUDING OBSERVATIONS

Many industry participants, especially those outside the United States, will view the NAIC's actions as overdue recognition of the need for fairer reinsurance collateral requirements. On the other side, detractors will likely continue to question the prudence of arguably less regulation through a process that relies materially on agency ratings, the potential frailties of which were underscored by the recent financial markets crisis.

Assuming the revisions to the Models go into effect on final adoption, only time will tell if relatively uniform adoption by all states will ensue in the near term. The absence of uniform adoption of the revised Models – *and uniform implementation thereof* – by the states could result

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[5] Presumably, the Financial Condition (E) Committee also adopted the Preface when it adopted the Task Force's revisions, subject to the Committee's additional modifications. However, inasmuch as the Financial Condition (E) Committee Meeting Summary Report does not expressly refer to the Preface, this is not entirely clear.

in state-by-state variation undermining a fundamental goal of regulatory modernization. In any case, as previously observed in our *Special Focus* article discussing New York's modification of Regulation 20, market realities in the end may dictate the pace at which states adopt the revised Models and how they implement same. If reforms like those in New York and Florida prove to increase capacity and decrease costs of reinsurance for domestic cedents, other states may be forced to follow in order to keep "level" yet another, arguably more fundamental playing field – that on which their own domestic insurers compete with insurers domiciled in other states.[6]

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[6] As of September 26, 2011, New York had certified 14 reinsurers for reduced collateral reinsurance writing. Of these 14, three achieved a Secure-2 rating, meaning they would be required to post collateral at a 10% level to allow the ceding company to take full reserve credit. The remaining certified reinsurers achieved a Secure-3 rating, which puts the collateral requirement for them at 20%. Ten of the certified reinsurers were certified for property/casualty business, two were certified for life, annuities, and accident/health lines, and the remaining two for both property/casualty and life, annuities, and accident/health. As of May 23, 2011, 14 reinsurers were authorized for reduced collateral reinsurance writing in Florida. Florida's current regulation applies only to property and casualty reinsurance.