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Credit for Reinsurance Change

They Said it Couldn't be Done

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About 30 years ago, U.S. regulators decided to use a then novel approach to "regulate" reinsurance cessions made by U.S. cedents to unauthorized reinsurers. Rather than attempting to analyze the financial condition and creditworthiness of unauthorized reinsurers, U.S. regulators embarked on a new regulatory scheme for these reinsurers. The "credit for reinsurance" paradigm was created as an alternative to regulators having to vet unauthorized reinsurers. It applied to both non-U.S. reinsurers as well as U.S. reinsurers which were unauthorized in the cedent's domicile. Over time, the concept of accredited/approved reinsurers evolved in the states, resulting in vetting those reinsurers wishing to become accredited or approved, albeit not to the same extent as for licensure. Although unauthorized U.S. reinsurers could become authorized or accredited, non-U.S. reinsurers faced greater obstacles, including the differing, and sometimes irreconcilable, solvency regimes of non-U.S. jurisdictions and the scarce resources of U.S. regulators.

Under the credit for reinsurance paradigm, U.S. cedents were allowed balance sheet credit for cessions made to unauthorized reinsurers that met certain criteria. The reinsurer could either become accredited or approved in the cedent's domiciliary jurisdiction or the cedent could hold collateral equal to 100 percent of the reserves ceded to the reinsurer. In either case, the cedent would be able to receive full balance sheet credit for the cession.

Several years ago, a group of unauthorized reinsurers approached the National Association of Insurance Commissioners ("NAIC") asking for a change in the 100 percent collateral requirement arguing that the requirements were costly and discriminatory. The NAIC Reinsurance Task Force began consideration of their request for some form of relief, which instantly met with opposition from U.S. cedents and their trade associations. Despite considerable opposition, the Reinsurance Task Force ultimately recommended the *Reinsurance Regulatory Modernization Framework* ("Framework"),[1] which included, *inter-alia*, provision for lowering the 100 percent collateral requirement for certain eligible non-U.S. reinsurers. The NAIC adopted the Framework and, in an effort to expedite implementation among all states, sought federal legislation to pre-empt the existing inconsistent state reinsurance laws.

The NAIC was unsuccessful in getting support in Congress for its Framework proposal. Congress was pre-occupied at the time with addressing perceived weaknesses in the regulation of the banking, securities and real estate industries. The Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank") was signed into law on July 21, 2010, and although not aimed at insurance companies, it directly impacted the insurance and reinsurance industries in a number of ways. Dodd-Frank includes the Non-admitted and Reinsurance Reform Act of 2010 ("NRRA"), which affected both surplus lines regulation and credit for reinsurance. In particular, its reinsurance provision states that only the cedent's home state may regulate credit for reinsurance, therefore ending the extraterritorial exercise of jurisdiction which some states had employed in this area.

Failing to obtain a fuller pre-emption from Congress, the NAIC again worked through the Reinsurance Task Force to amend its model laws to accomplish the objectives of the Framework.

After months of meetings, hearings and telephone conference calls, and over the objections of U.S. domestic insurers and their trade associations, the Reinsurance Task Force and its parent committee, the Financial

Condition (E) Committee, adopted amendments to the Credit for Reinsurance Model Law and Regulation to implement the Framework. Although certain individual cedents remained opposed to collateral reduction until the end, the trade associations that had also opposed the changes, withdrew their opposition. The amendments were adopted at the November 6, 2011, Executive and Plenary NAIC meeting with two last-minute revisions. The first change attempts to insure state uniformity in determining qualified jurisdictions. In order for a non-U.S. reinsurer to be certified, it must be domiciled in a qualified jurisdiction. The second change address concerns raised by cedents regarding over concentration of risk. This change requires ceding insurers to manage reinsurance recoverables and diversify their reinsurance programs.[2]

The amendments now provide for cedents to receive full credit for reinsurance cessions to so-called "certified" non-U.S. reinsurers without obtaining 100 percent collateral as was previously required. Now these reinsurers need only post a collateral percentage based on the "secure level" assigned by its U.S. regulator, which is determined by rating agency ratings and other factors. The amount of collateral required is as follows:

Ratings	Security Required
Secure – 1	0%
Secure – 2	10%
Secure – 3	20%
Secure – 4	50%
Secure – 5	75%
Vulnerable – 6	100%

Thus, a certified reinsurer rated at Secure - 3 must post 20 percent collateral in order for the cedent to obtain full balance sheet credit.

In addition, there are other changes to the way cedents may get full credit. Cessions to insurers that maintain multi-beneficiary trust funds, as was the case prior to the amendments, also qualify for full balance sheet credit with reduced collateral. The certified reinsurer must maintain separate trust accounts for its obligations incurred under reinsurance agreements issued or renewed as a certified reinsurer with reduced security and for its obligations, where full collateral is still required. As a condition to the grant of certification, the certified reinsurer must enter into an agreement with the commissioner with principal regulatory oversight of each such trust account, to apply any remaining surplus of such trust upon its termination toward any deficiency of any other such trust account.

In addition, a reinsurer in run-off for at least three years may be permitted to reduce its $20 million minimum multi-beneficiary trusteed surplus requirement to a lesser amount, but not lower than 30 percent of the reserves attributable to the trust. This requires the prior written approval of the commissioner with principal regulatory oversight over the trust.

Several states[3] have already changed their respective laws or regulations to permit reduced collateral. In order for the unauthorized reinsurers to get full relief it will be necessary for more states to follow suit.

Romano and Keir participated in and followed the activities that led up to these changes.

Endnotes

1 *The Framework called for the creation of a vetting office that would certify reinsurers and their respective domiciliary jurisdictions. The NAIC felt that federal law was necessary to create this office. Absent the legislation, the NAIC abandoned this idea and opted to include in the model law amendments most of the other provisions in the Framework.*

2 *This requirement mirrors requirement in New York's Regulation No. 20 (11 NYCRR 125.4)*

3 *Florida, Indiana, New Jersey and New York (See, Locke Lord Quick Study, January 24, 2011)*

For more information on the matters discussed in this Locke Lord QuickStudy, please contact the authors:

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