CHANGES IN U.S. CREDIT FOR REINSURANCE LAWS[1]

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Introduction

Credit for reinsurance laws are a critical factor in regulating reinsurance in the United States. These laws determine the conditions under which a ceding insurer domiciled or licensed in a state can take financial statement credit for the reinsurance either as an asset or as a reduction of liabilities.[3] As such, credit for reinsurance laws contain a powerful incentive for compliance since there are few situations in which a ceding insurer would be willing to pay out premiums to a reinsurer without being able to reflect a corresponding increase in assets or reduction in its liabilities as a result of the cession.

For several years, changes have been considered in U.S. credit for reinsurance laws.[4] The reason for such consideration was a desire to increase the reliability of security with respect to certain reinsurers which are not licensed in the U.S. These changes are quite timely in light of the recent New York Examination Report which found that the Lloyds' American Trust Fund, which collateralizes its obligations to U.S. policyholders and cedents, is underfunded by $18.5 billion.[5]

National Association of Insurance Commissioners

In the U.S., model laws, regulations and financial statements are developed by a trade association of state insurance regulators known as the National Association of Insurance Commissioners ("NAIC"). The NAIC has developed an accreditation program to encourage, among other things, substantial similarity of state laws and procedures in key areas of solvency regulation. Credit for reinsurance is one such area[6] and the NAIC has a recommended credit for reinsurance model law ("Model Law") and regulation ("Model Regulation") on point. Virtually all states have some variation of the Model Law and Regulation on their books.[7]

In February of 1990, the Subcommittee on Oversight and Investigations of the Committee on Energy and Commerce of the U.S. House of Representations issued a report entitled *Failed Promises: Insurance Company Insolvencies* ("Failed Promises"). This report described the insolvencies of four large property and casualty insurers during the mid-1980's. Failed Promises reserved some of its most severe criticism for the state system of regulating foreign (non-U.S.) reinsurers calling it the "black hole of solvency regulation." Shortly thereafter the Energy and Commerce Committee began drafting Federal legislation designed to remedy the various problems with state regulation outlined in Failed Promises.[8]

The NAIC reacted to this threat by adopting a number of reforms, including the accreditation program described above. Credit for reinsurance reform has had one of the longer gestation periods of the various means utilized by the NAIC to stave off Federal regulation. It now appears that the NAIC will amend its Model Law and Regulation by the end of 1995.

The Lloyds' Factor

The specter of Federal legislation faded in 1994 after the Republicans took control of the U.S. Senate and House.[9] By that time, however, interest in credit for reinsurance matters were being fueled by problems at Lloyds' of London. These problems included:

• £5 billion in losses over five years;

• Charges of negligence and self dealing on the part of agents, underwriters, auditors and Lloyds' itself;

• Suits by thousands of names seeking compensation for crushing losses; and

• Questions whether Lloyds' should or could meet its obligations on "old year" losses from the U.S.[10]

These problems caused U.S. creditors and regulators to look toward the Lloyds' American Trust Fund ("LATF"), a premium trust fund formed by Lloyds' in 1939 as World War II loomed across Europe. The LATF is the device by which Lloyds' collateralizes its obligations to ceding insurers and policyholders. The result of this scrutiny was a much higher level of concern with the adequacy and accessibility of the LATF.[11] In 1994, New York initiated the first ever examination of the LATF. The report, issued in May of 1995, found:

• Lloyds' was violating its own solvency tests in calculating the liabilities secured by the LATF;

• Lloyds' was funding the trust on a net of reinsurance basis rather than a gross basis as required by New York law;

• The LATF was underfunded by $7.8 billion on a net basis and $18.5 billion on a gross basis; and

• Lloyds' failed to transfer to the LATF, funds earmarked from the Central Fund to cover bad debts.[12]

These findings jeopardize the ability of cedents in New York, if not other states, to take credit for reinsurance ceded to Lloyds'.[13] This could result in rating changes or even insolvency for Lloyds' ceding companies. As a result, the Lloyds' factor is the single most important issue driving change in the Model Law and Regulation at this time.

<u>Changes to the Trust Funds</u>

In general terms, U.S. credit for reinsurance laws separate reinsurers into two categories - those which are treated as licensed and those which are treated as unlicensed. Licensed treatment is available under section one for reinsurers which: (a) are licensed in the domiciliary state of the ceding company; (b) are accredited (an abbreviated licensing process) in such state; or (c) are domiciled in states which employ standards for credit for reinsurance substantially similar to those of the domiciliary state of the ceding company. Other reinsurers must post collateral to secure their obligations to ceding companies.[14]

Through a quirk of legislative development, the Model Act has two very different sections dealing with the manner in which unlicensed (usually foreign) reinsurers can collateralize their obligations.[15] By far the most widely used methodology is section two which requires such reinsurers to post a letter of credit or funds in trust for each ceding insurer. The liabilities funded are gross liabilities including IBNR. These devices have worked well and the NAIC is not considering any material change to the section two collateralization devices.[16]

In addition to credit for reinsurance for cessions to licensed, accredited and "substantially similar" reinsurers, section one allows credit for cessions to reinsurers which post a single trust for all U.S. creditors. In contrast to section two trusts, however, the section one trusts are relatively unstructured.[17] Lloyds' and a few other entities have formed section one trusts. These section one trusts are the focus of the more material changes proposed by the NAIC.

The basic structure of section one trusts have remained largely intact in the most current draft of amendments. Individual reinsurance companies must post liabilities to ceding insurers plus $20 million of trusteed surplus. Groups with individual and corporate underwriters (such as Lloyds') must post liabilities to ceding insurers plus $100 million of trusteed surplus. Groups of corporate underwriters (such as the Institute of London Underwriters) must post liabilities to ceding insurers plus $100 million of trusteed surplus.

Trust funds equal to liabilities for the two group trusts are posted on a "several" basis meaning that one investor is not liable for the debts of another. Some creditors lobbied for a joint trust as superior security since there is no mechanism in the law to require each underwriter to properly collateralize their obligations. However, the NAIC did not adopt this position.[18] While the $100 million surplus margin is joint for the benefit of all cedents, this is a very small sliver of the $30 billion in Lloyds' U.S. liabilities as estimated by the New York Insurance Department in its May 1995 examination report. Even under the amended Model Law, creditors may not be able to recover if the trust is underfunded or their particular debtors have insufficient assets in the trust.[19]

The amendments work a number of significant changes, however. Initially, the Regulation specifies that liabilities which must be funded are gross of reinsurance. It is clear from the discussions of regulators at the NAIC and the minutes of their meetings that this amendment is meant to clarify their pre-existing understanding of "liabilities" rather than to change the way in which liabilities are meant to be funded.[20]

The existing LATF covers policyholders as well as ceding insurers. The proposed amendments to the Model Law would change this to delete policyholders since in the future they would be covered by a separate trust under the surplus lines law. In addition, Lloyds' would be allowed to establish a new trust to fund business going forward and would be allowed to run off old business under the LATF. The proposed amendments to the Regulation adopt investment guidelines for assets in the section one trusts.

The form of the trust fund must be approved by the chief insurance supervisory official of the state in which the trust is located or such official of another state who has accepted principal regulatory authority over the trust. Commissioners of states in which ceding insurers are domiciled get a copy of the trust form but are not required to approve it. Arguably, this weakens the current Model Law which requires the commissioner of each state in which a ceding insurer is domiciled to approve the form of the trust. Practicality and heightened awareness of the problems of trust funds among regulators are balancing factors. However, this change to the Model Law would allow a reinsurer to forum shop for the most lenient regulation of the trust. This can be a significant problem since the actual form of the trust does much to affect its security and accessibility.

The Extra-Territoriality Problem

The NAIC accreditation program was designed to raise the quality of state regulation and to harmonize it among the states. Unfortunately, some states are reluctant to accept a finding by a ceding insurer's domiciliary state that a particular reinsurer qualifies for credit for reinsurance. This is called extra-territorial regulation since the non-domiciliary state is attempting to regulate beyond its borders. This can result in a situation where a domiciliary state allows the ceding company credit for reinsurance while another state does not, causing a ceding company's surplus to change from state to state. Such a result has been much criticized by the industry.[21]

A compromise has been developed to mitigate the effects of extra territoriality. An optional section has been included in the Model Law which calls for states to recognize the credit for reinsurance determinations of the ceding insurer's domiciliary state if:

• Such state is accredited by the NAIC; or

• The transaction qualifies for credit under the laws of the non-domiciliary state raising the question.

However, a state may reject the decision of the domiciliary state if the condition of the reinsurer or the collateral provided do not meet the standards of the state raising the question. In practice, it is likely that a domiciliary state's ruling will stand unless another state, for cause, takes affirmative action to deny credit. Hopefully, this will occur seldom so that ceding insurers will not have to endure swings in surplus from state to state.

Conclusion

After several years of study and drafting, the NAIC is close to the adoption of amendments to the Model Credit for Reinsurance Law and Regulation. These changes have not been rapid nor have they addressed all the problems with section one trust funds. They have, however, been well considered and drafted. Hopefully, these amendments will help prevent foreign reinsurance from being in the future (if it ever was) the "black hole" described in Failed Promises.

ENDNOTES

1. This article was originally published by the International Journal of Insurance Regulation.

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3. *See* Robert M. Hall, *Security Devices For Unlicensed Reinsurers*, Un. of Pa. Journal of Intl. Bus. Law, Vol. 16 No. 1, Spring 1995 at 42-46 [hereinafter *Security Devices*].

4. *Id*. at 78-9.

5. *Report of Examination of Lloyds' London* as of December 31, 1993, New York Insurance Department, May 11, 1995 at 24 [hereinafter *Report of Examination*].

6. Robert M. Hall, *Unfinished Business, Best's Review*, Vol. 92 No. 5, September 1991 of 75 [hereinafter *Unfinished Business*].

7. *Security Devices* at 42.

8. Debra J. Hall, *Credit for Reinsurance: An Ongoing Regulatory Debate, Reinsurance Fundamentals and New Challenges*, Insurance Information Institute Press, 3rd Edition, 1995 at 134-5 [hereinafter *New Challenges*].

9. *Id*. at 137.

10. *Security Devices* at 66-78.

11. *Id*. at 78-9.

12. *See generally, Report of Examination*.

13. *See Security Devices* at 62.

14. *New Challenges* at 129-130.

15. *Id*.

16. *Unfinished Business* at 75-6.

17. *Security Devices* at 46-66.

18. *Regulatory Debate* at 132.

19. *Security Devices* at 50-57.

20. *Id*. at 78-9.

21. *New Challenges* at 130.