9 Credit for Reinsurance: An On-Going Regulatory Debate

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I. Background

The origins of reinsurance are, in all likelihood, as ancient as insurance itself,[1] although reinsurance was not practiced as a separate and distinct business until the 19th century.[2] During the period of economic expansion following World War II, the rising number of reinsurance transactions and the increasing importance of reinsurance to insurers caused insurance regulators and the National Association of Insurance Commissioners (NAIC) to focus directly on this part of the insurance industry.[3] U.S. regulators have been grappling with a number of reinsurance issues ever since, in particular, the standards by which an insurer should be allowed to take credit for reinsurance ceded to an assuming insurer. This article provides an overview of the historical development of some of the key issues, as well as insight into the current status of the credit for reinsurance debate.

A Glimpse Back to 1949

At the 1949 NAIC annual meeting, state insurance commissioners noted that some disturbing abuses of reinsurance had come to the attention of various insurance departments, including abuses of the allowance of credit for non-admitted reinsurance.[4]

The Subcommittee to Study the Question of Reinsurance (Subcommittee) submitted a report to the Executive Committee at the 1950 NAIC meeting, recommending that credit for reinsurance ceded "be based upon the actual value of the reinsurance and the security underlying the collectability and not on the basis of the license of the reinsurer."[5] In furtherance of this concept, the Subcommittee made certain recommendations[6] but no action was taken at that time. The recommendations were still being discussed at the NAIC more than three decades later.

Credit Revisited in 1980s

In 1982, the Illinois Department of Insurance (Illinois Dept.) submitted a report to the Reinsurance Syndicates and Pools and the Anti-Fraud Task Forces in which it advocated steps to curb fraudulent reinsurance practices and promote earlier detection of fraud.[7]

Among the suggestions proposed by the Illinois Dept. was the development of a model law on reinsurance which would create financial standards for assuming reinsurers, accounting for reinsurance transactions and reserve credits, circumstances for prior approval of reinsurance arrangements, required provisions for reinsurance contracts and financial reporting and disclosure of certain reinsurance transactions.[8]

In a subsequent report, *Reinsurance Problems and Solutions: An Illinois Alternative*, the Illinois Dept. made specific proposals for improving reinsurance regulation.[9] The report noted the status of credit for reinsurance at that time:

> Every state permits domestic insurers to take annual statement credits for reinsurance cessions made to "admitted reinsurers." However, state insurance laws and regulations appear to be quite diverse in defining their terms. Illinois statutes, for example,

permit domestic companies to cede to any insurer, regardless of size, authorized to transact the direct business of insurance in Illinois; conversely, except in rare circumstances, reinsurance credit may not be taken for reinsurance ceded to an unlicensed company regardless of its financial standing... Even those states which only authorize reinsurance credit for cessions made to particular insurers allow credit if the ceding company holds some sort of collateral, such as actual funds or letters of credit, to the extent credit is taken.[10]

As a result of the work of the NAIC task forces, the first model law addressing credit for reinsurance was adopted in June 1984.[11]

II. Current Model Law on Credit for Reinsurance

Historically, the laws governing credit for reinsurance were based upon the concept that credit for reinsurance ceded was allowed when the reinsurer was licensed or provided sufficient collateral.[12]

Over the past 45 years, certain exceptions to that basic concept have been made. Today, under the NAIC's Model Law on Credit for Reinsurance,[13] reinsurance may be treated as an asset on the ceding insurer's financial statement if:

- the reinsurer is licensed in the ceding insurer's state of domicile (licensed)[14]
- the reinsurer is "accredited," that is, in compliance with certain accreditation requirements set forth in the model law[15]
- the reinsurer is licensed in its domiciliary state and that state's credit for reinsurance law is substantially similar to the law in the ceding insurer's domiciliary state and certain other requirements are met (substantially similar),[16] or
- the reinsurer establishes a trust fund in which it secures liabilities of multiple creditors (multiple creditor trusts).[17]

The Credit Model Law treats reinsurers qualifying under the "accredited," "substantially similar" and "multiple creditor trust" provisions in the same manner as if those reinsurers were licensed in the ceding insurer's state of domicile.

Even if cessions to a reinsurer do not qualify for treatment as an asset, credit for reinsurance may still be allowed as a deduction from liability to the extent that the reinsurer collateralizes its obligations

to the ceding insurer through letters of credit, trust funds (single creditor trusts), funds withheld or other security acceptable to the commissioner of insurance.[18] A model credit for reinsurance regulation (as distinct from the model law, adopted earlier) was adopted by the NAIC in 1991, which further specifies the requirements necessary for credit purposes.[19]

III. Current Issues

Despite the model law and model regulation, a number of issues related to credit for reinsurance are still controversial. The current disputes among regulators and various segments of the reinsurance industry can be traced back through the decades, some as far back as the 1950s.

Domestic vs. Licensed

There is still considerable disagreement among regulators, and between some regulators and the industry, concerning the extraterritorial application of credit for reinsurance laws. Approximately 13 states[20] have departed from the Credit Model Law and applied their laws, through interpretation or statute, to a licensed company instead of on a domiciliary basis. In other words, a ceding insurer that normally follows the laws of its state of domicile in calculating reinsurance and other credit, must follow different laws if it is licensed in any of these 13 states that have deviated from the model law. The industry has opposed the actions of these states, arguing that ceding insurers will be required to restate annual financial statements on a state-by-state basis, if this practice is allowed to continue. Both the industry and other regulators have charged, in addition, that such actions undercut the NAIC accreditation program and the reliability and effectiveness of state regulation.

Insolvency Clause

The model regulation contains a requirement that, for a ceding insurer to take credit for reinsurance, the reinsurance contract must con-

tain an "insolvency clause."[21] Essentially, an insolvency clause requires that in the event of the insolvency of the ceding insurer, all reinsurance payments due shall be made to the receiver without reduction due to the insolvency of the ceding insurer. In 1989, there was an attempt to draft a model insolvency clause, but the effort was abandoned on account of what appeared to be an irreconcilable difference between regulators in New York and California.

In 1993, receivers entered the insolvency clause debate. As part of its efforts to amend the Insurers Rehabilitation and Liquidation Model Act, an NAIC working group suggested specific insolvency clause language. Instead of recognizing that the provision included in the model law is a requirement for credit purposes only, and that the parties are free to exclude it if no credit is taken for reinsurance, the receivers sought to make the clause a reinsurance contract requirement. They would require that any reinsurance contract not containing the specific language would be construed as if that language *were* a part of the contract. Both industry and regulators have objected to this proposal.[22]

At a meeting of the NAIC in December 1994, there was a compromise and amendments to the Insurers Rehabilitation and Liquidation Model Act were approved. That compromise provides that any reinsurance contract not containing an insolvency clause will be construed to include the prescribed language, regardless of whether the ceding insurer took credit for the reinsurance recoveries. Contracting parties may avoid this result by including their own insolvency clause language in the contract, even in those contracts where no credit for reinsurance recoveries is contemplated.

Lloyd's of London

Pursuant to the multiple creditor trust provisions of the current model law, a ceding insurer is allowed to take credit for reinsurance ceded to Lloyd's as if Lloyd's were a licensed reinsurer. Lloyd's is required to secure its U.S. liabilities in a U.S. financial institution and to maintain a trusteed surplus of $100 million (the "Lloyd's

American Trust Fund" or "LATF").

The LATF consists primarily of premiums payable to an individual "Name"[23] in connection with U.S. business.[24] The liabilities of Names are several — not joint. In other words, one Name is not responsible for the debts of another Name. Only the $100 million of trusteed surplus is held jointly for the benefit of all "policyholders."[25]

In 1993, the Reinsurance Association of America (RAA) advocated a change to the Credit Model Law that would require that all multiple creditor trusts, including Lloyd's, be held on a joint basis.[26] The RAA asserted that a joint trust was necessary to ensure that ceding insurers that take credit for reinsurance ceded to Lloyd's syndicates are adequately collateralized, regardless of the amount of funds that an individual Name maintains in the LATF. Lloyd's opposed this position on the basis that its unique structure would not allow for the funds to be held jointly and because Lloyd's maintains that sufficient security is in place to protect U.S. creditors.

Like many issues in the credit for reinsurance area, this subject has been the focus of debate for decades. In 1950, the Subcommittee of insurance commissioners reported that one of three necessary changes to the law with respect to Lloyd's was the need for

> Some definite provision to be made to assure the availability of assets in the [LATF] for the payment of liabilities in the United States regardless of the individual "Names" to which such funds belong. The method of accounting between the "Names" and the method of reimbursement that might be made in England between the "Names" is a matter of no particular moment to a ceding company that has large claims against certain Lloyd's Underwriters.[27]

The Subcommittee subsequently recommended that the exclusion for Lloyd's with respect to accounting treatment for alien reinsurers be eliminated and that Lloyd's be treated like any other alien reinsurer.[28] In other words, it was determined that Lloyd's should provide collateral to individual ceding insurers to secure its obligations to those entities. This recommendation was approved by the NAIC,[29] but after special hearings were held, the issue was eliminated from the NAIC's agenda in favor of leaving the determination to

individual states.[30]

The manner in which ceding insurers should be allowed credit for cessions to Lloyd's has been revisited in the intervening years.[31]

Institute of London Underwriters

In June 1987, the NAIC first discussed the allowance of credit for the Institute of London Underwriters (ILU).[32] It was noted that the ILU had approached the Maryland Department of Insurance with a proposal to accept the ILU member companies, as a group, for credit purposes.[33] Maryland's acceptance of this proposal was viewed by other regulators as a significant departure from the historical approach taken in the Credit Model Law.

In 1989 the Reinsurance Task Force approved an amendment to the Credit Model Law which provided an exception for incorporated insurers under common administration.[34] Like the Lloyd's provision, the ILU was an exception to the longstanding concept that credit be granted for companies that were either licensed or that provided collateral to the ceding insurer.

In 1993, the RAA advocated that the ILU provision of the Credit Model Law, which requires an amount equal to U.S. liabilities plus $100 million of joint trusteed surplus,[35] be amended to require that all funds be held for the joint benefit of all ceding insurers, for the same reason expressed in reference to the LATF established by Lloyd's.[36]

The RAA's suggested amendments with respect to both the Lloyd's and ILU trusts have not been adopted by the NAIC. However, approximately 13 states or U.S. territories have not adopted the ILU trust provision, or, alternatively, have not adopted any of the multiple creditor trust provisions. In those jurisdictions, reinsurers must qualify for credit through other avenues available in those states' laws.

Minimum Capital and Surplus

The amount of surplus that assuming reinsurers, both domestic and alien, should be required to maintain has been a recurring topic of discussion. In June 1984, the NAIC adopted a requirement that reinsurers qualifying under the "substantially similar" provision maintain, at a minimum, the same capital and surplus required of a domestic insurer in the ceding insurer's state of domicile.[37]

In 1988, the Reinsurance Task Force established a working group to consider whether a separate license should be established for reinsurers.[38] The Reinsurance Industry Advisory Committee and the working group concluded that instead of having a separate reinsurance license, an insurer assuming reinsurance liabilities should be required to increase its surplus.[39]

This issue continues to be controversial at the federal level where proposals to regulate the solvency of reinsurers are being discussed. Some reinsurance companies have supported a minimum requirement of $50 million for the assumption of reinsurance by professional reinsurers. Smaller companies writing some reinsurance have opposed even the imposition of a $5 million threshold.[40]

IV. The Focus of Reinsurance Regulation Expanded to the Federal Level

In recent years, the focus of reinsurance regulation has moved to the federal level. In February 1990, the House of Representatives, Committee on Energy and Commerce, Subcommittee on Oversight and Investigations, chaired by Congressman John Dingell (D-MI), released a report, *Failed Promises*, which examined the causes of insurance company failures in the United States.[41] The report noted numerous weaknesses in the state regulatory system and, in particular, identified a number of reinsurance-related abuses.

Following the publication of the report, Chairman Dingell introduced H.R. 4900, followed shortly thereafter by H.R. 1290,[42] which proposed the transfer of regulation of reinsurance from the states to a Federal Commission. Although health care and Superfund reau-

thorization detoured the Congress during the (103rd) session, Congressman Dingell noted that he intended to introduce a "mini-bill," which would have provided for the federal regulation of reinsurers, surplus lines, industrial insureds and perhaps, the licensing of brokers.[43]

The domestic reinsurance industry has, in large part, supported Congressman Dingell's initiatives in H.R. 1290.[44] Even the NAIC has recognized the need for federal assistance in the area of alien reinsurance. At its meeting in December 1992, the NAIC adopted, in large part as a response to *Failed Promises*, the concept of federal assistance and this was later embodied in the Non-U.S. Insurer Act.[45] It establishes the NAIC or its Non-Admitted Insurers Information Office as the "gatekeeper." A non-U.S. direct insurer would be prohibited from writing business in the United States unless it was approved by the NAIC. Similarly, as a condition of a ceding insurer taking credit for reinsurance, a non-U.S. reinsurer would first have to be approved by the NAIC. The Act sets forth the qualifications of NAIC approval and procedures for the Department of Treasury to act as an oversight authority.[46]

Although the Non-U.S. Insurer Act has not been introduced in Congress, it is likely that it would meet with objections from the domestic reinsurance industry.[47]

V. How Credit for Reinsurance Is Addressed in the Federal Proposals

The Non-U.S. Insurer Act was designed to centralize authority with respect to alien insurers and reinsurers and, at the same time, maintain the current practice with regard to the regulation of domestic insurers and reinsurers. However, the result would be an advantage for alien companies over their domestic counterparts. Alien companies could conceivably have to apply for NAIC approval only once, [48] and this would open the door for the conduct of business nationwide, while domestic companies would continue to be burdened with the present state-by-state system of regulation, which forces them to deal

individually with each of the states in which they wish to do business. Unlike the Non-U.S. Insurer Act, H.R. 1290 offered the ability to do business through a single regulatory mechanism to all reinsurers, domestic and alien.

H.R. 1290 provided for the federal certification of professional reinsurers and required a minimum net worth of $50 million, or more, based on the reinsurer's operations, e.g., premium volume, volatility and loss development characteristics.

Under the proposal, a reinsurance department of a primary insurer may assume reinsurance risks by complying with certain standards, including a net worth of $5 million, though the amount of net worth may be increased or decreased based on certain circumstances.

Credit for reinsurance is allowed for a ceding insurer that contracts with a professional reinsurer or a reinsurance department of a primary insurer.

H.R. 1290 provided for multiple creditor trusts, similar to the Credit Model Law. Likewise, insurers ceding to reinsurers not meeting these requirements could obtain credit for reinsurance, as a reduction from liabilities, if the reinsurer funded its obligations in a manner acceptable to the Commission.

In addition to the above requirements, H.R. 1290 imposed a number of other obligations on alien reinsurers, including a provision that the reinsurer file annually with the Commission a translated financial statement, a list of officers and directors, and other biographical information. H.R. 1290 also required alien reinsurers to submit to examination, and to agree to waive any protection provided by its domiciliary country's secrecy laws.

The provisions of the NAIC Non-U.S. Insurer Act reduce the trust fund required of some multiple creditor trusts from $20 million plus an amount for U.S. liabilities, to only *$5 million in total* — that is, without any funding of U.S. liabilities. The multiple creditor trusts required of Lloyd's and the ILU would remain essentially the same as that required in the Credit Model Law.

VI. The Republican Landslide of 1994

With Republicans winning a historic majority in both Houses of Congress as a result of the November 1994 elections, a radical realignment of chairpersons, coalitions and constituency groups has occurred in Washington. Congressman Dingell no longer chairs the House Energy and Commerce Committee and Republicans are expected to support continued state regulation.

As noted, the non-U.S. Insurer Act was proposed by the NAIC as a result of recognition by state regulators that some federal assistance was needed to adequately address the issue of alien insurers and reinsurers. Several state regulators have advocated the use of interstate compacts instead of federal legislation for this and other regulatory purposes. It is likely that the NAIC and state regulators will continue to debate the merits of the interstate compact approach until interest in federal regulation is renewed.

VII. Conclusion

The debate over a number of substantive issues relating to credit for reinsurance, now at least 45 years old, will likely continue into the future at both the NAIC and individual state levels. The recent federal proposals tend to treat these issues in a manner, which is not substantially different from the Credit Model Law with respect to collateralization. Consequently, debate will continue to focus both on the requirements that must be met before a ceding company can receive credit for reinsurance and the level of government at which those credit-for-reinsurance standards should be established and implemented.

[1] J.S. Butler & R.M. Merkin, *Reinsurance Law* A.2.1-01 (1988 & Supp. 1991). The first reinsurance contract dates back to the year 1370 but the development of reinsurance as it exists today can be credited to the fire insurance business. *National Association of Insurance Commissioners Proceedings, Report to the Sub-Committee to Study the Question of Re-Insurance,* I:475 (1950) [hereinafter *NAIC Proceedings* 1950]

[2] Cologne Reinsurance Company, the first independent reinsurance company, was founded in 1846. The first U.S. reinsurance company was not organized until the

early years of the present century. *NAIC Proceedings* 1950 p.476 and *Insurance Accounting and Statistical Association, Insurance Accounting Fire & Casualty* 85 (2nd Ed. 1965)

[3] J.F. Bank, *The Regulation of Reinsurance, in the State of Insurance Regulation* 128 (American Bar Association 1991)

[4] *NAIC Proceedings* 1950, *supra* note 1, at 49-50

[5] *Id.* at 449

[6] *Id.*

ers while others fail to specifically limit application to domestic insurers.

[21] *Credit Regulation*, *supra* note 19, § 13A

[22] Report of Resource Group to the Model Law on Credit for Reinsurance Working Group in a Letter to Robert Solitro, Deputy Commissioner, New Hampshire Department of Insurance (April 8, 1994). *Minutes of Model Law on Credit for Reinsurance Working Group of the Special Insurance Issues (E) Committee* (May 4, 1994)

[23] Lloyd's of London is an association of individual members who write insurance for their own account and maintain unlimited personal liability to their insureds. A "Name" refers to one class of membership at Lloyd's, an underwriting member. An underwriting member is allowed to write insurance while a nonunderwriting member acts in a brokerage capacity on behalf of the general public and the underwriting members or Names. See R. Mehr, E. Commack, *Principles of Insurance* 46-53 (1960). See also chapter on Lloyd's in this book. In 1994, corporate Names, with limited liability, were admitted to Lloyd's.

[24] *NAIC Proceedings* 1950, *supra* note 1, at 458

[25] *Credit Model Law, supra* note 11, § 1D. The trust deed states that the trust is for the benefit of all "policyholders". U.S. insolvency law has held that ceding insurers are not "policyholders." The trust deed also provides that the rights of all parties are to be governed in accordance with New York law, which raises a question about how the reference to "policyholders" would be determined as it relates to ceding insurers.

[26] Letter from Reinsurance Association of America to Robert Solitro, Deputy Commissioner, New Hampshire Department of Insurance (Nov. 24, 1993) [hereinafter *Solitro Letter*]

[27] *NAIC Proceedings* 1950, *supra* note 1, at 458

[28] *Id.* at 449

[29] See *NAIC Proceedings* 1954, *supra* note 12, at 424

[30] *Id.* at 461-74

[31] See, e.g., *National Association of Insurance Commissioners Proceedings, Report to the (E5) Reinsurance, Syndicates, and Pools Task Force and (E6) Anti-Fraud Task Force, II:893 (1983); National Association of Insurance Commissioners Proceedings, Reinsurance (E) Task Force, Report of Model on Credit for Reinsurance Working Group,* II:727-28 (1989); *National Association of Insurance Commissioners Proceedings, Reinsurance and Anti-Fraud (E) Task Force, Working Group Regarding the Model Law on Credit for Reinsurance*, B:895 (1990) [Hereinafter *NAIC Proceedings* 1990]

[32] *National Association of Insurance Commissioners Proceedings, Report of the Special Insurance Issues (E) Committee*, II:833 and 854 (1987)

[33] *Id.* at 833

[34] *NAIC Proceedings*, 1990, *supra* note 31, at 851 and 891

[35] *Id.* at 855-59

[36] *Solitro Letter, supra* note 26

[37] *National Association of Insurance Commissioners Proceedings, Report to Reinsurance and Anti-Fraud (E) Task Force*, II:838 (1984)

[38] *National Association of Insurance Commissioners Proceedings, Report to Reinsurance and Anti-Fraud (E) Task Force*, II:804 (1988)

[39] *Id.* at 808

[40] Discussion of minimum required surplus, 1993: Hearings on H.1290 before the Subcommittee on Commerce, Consumer Protection, and Competitiveness of the House Committee on Energy and Commerce, 103rd Cong., 1st Sess. 286-87 and 298 (1993) (Statement of Lee Bondhus, President and CEO, Reinsurance Assoc. of Minnesota)

[41] Subcommittee on Oversight and Investigations, House Committee on Energy and Commerce, *Failed Promises: Insurance Company Insolvencies*, 101st Cong., 2nd Sess. (Comm. Print 1990)

[42] The Federal Insurance Solvency Act of 1993 was introduced and referred to the House Committee on Energy and Commerce on March 10, 1993. It should be noted that, in addition to addressing reinsurance regulation, the Act also speaks to primary insurance and brokerage issues.

[43] Speech by Congressman John D. Dingell (D-MI) before the 1994 BIPAR General Assembly (May 17, 1994)

[44] Domestic reinsurer's support of the regulation of reinsurance, 1993: Hearings on H.1290 before the Subcommittee on Commerce, Consumer Protection, and Competitiveness of the House Committee on Energy and Commerce, 103rd Cong., 1st Sess. 266 (1993) (Statement of Sandra L. LaFevre, assistant vice president, Reinsurance Assoc. of America)

[45] *National Association of Insurance Commissioners, Report of the Executive (EX) Committee*, IA:136 (1993) [Hereinafter *NAIC Proceedings* 1993]

[46] *Id.* at § 7E

[47] Letter from Reinsurance Association of America to all members of the Committee on Banking, Finance and Urban Affairs of the United States House of Representatives (July 28, 1993)

[48] While some argue that individual states could require additional regulation or regulatory approvals, it is likely that such additional requirements would be pro forma and result, as a substantive matter, in a single license.