

Think Tank

U.S. Reinsurance Regulatory Framework Revisited¹

By Debra J. Hall



Debra J. Hall

Introduction

In March of 2006 The Reinsurance (E) Task Force (the Task Force) invited Industry Interested Persons (IPs) comprised of insurers, reinsurers, law firms and others to respond to *the NAIC Joint Executive (EX) Committee and Plenary Meeting's charge to the Task Force*. The Task Force was charged with developing alternatives to the current reinsurance regulatory framework, including the use of collateral within the U.S. and abroad.

The Task Force was asked to consider approaches that account for a reinsurer's financial strength regardless of domicile, i.e., state or country, and to identify and consider variations in state law and regulation relative to reinsurance contracts, financial reporting, etc.

The IPs presented their initial response at the Fall 2006 NAIC meeting. The IPs' proposal first identified the critical functions of reinsurance, which include expanding insurance company capacity, stabilizing underwriting results, financing, providing catastrophe protection, facilitating withdrawal from a line or class of business, and spreading of risk.

Several factors have prompted an interest in how reinsurers are regulated. These include the globalization of insurance and reinsurance, which has resulted

¹ Based on the presentation of the Interested Persons to the Reinsurance (E) Task Force. These proposals presented to the NAIC were edited for publication in AIRROC Matters, but the content reflects the substance of those proposals.

Debra J. Hall is Vice President and Regulatory Counsel for Swiss Re America Holding Corporation. She also serves as the p/c chair of the Interested Persons to the NAIC Reinsurance Task Force. This paper is intended to be an overview of the work product of the Interested Persons. Any views expressed herein are not necessarily those of Swiss Re America Holding Corporation or any of its affiliates or the Interested Persons. She can be reached at debra_hall@swissre.com.

in recent market domination by non-U.S. reinsurers, and substantial increases in cross border reinsurance. Globalization has also produced significant progress in the development of international accounting standards, and a movement toward regional regulatory harmonization as evidenced by the EU Reinsurance Directive, prompting the need for change in how reinsurance is regulated in the US. A number of state insurance regulators have acknowledged that such market development necessitates consideration of whether a different type of regulatory framework for reinsurance in the US is warranted.

The IPs are also working on proposals to eliminate or reduce the collateral required to be established by unauthorized reinsurers under credit for reinsurance laws. This aspect of the IPs' proposal is not discussed in this article.

The complexity and global nature of the reinsurance market require that the direct and indirect supervision of reinsurers and reinsurance needs to be regulated by one regulator in the US.

Proposals for a New Reinsurance Regulatory Framework

The IPs have developed a set of Core Principles and Standards (Core Principles) that at least some IPs believe should provide the framework for any future changes to the current reinsurance regulatory framework. While much work needs to be done to build consensus among industry, regulators, as well as certain IPs, the identification of these Core Principles was a bold first step in what will be an ongoing effort to effect constructive change to the current reinsurance regulatory framework.

The Core Principles are:

1. *Single Regulator for Reinsurance* — The complexity and global nature of the reinsurance market require that the direct and indirect supervision of reinsurers and reinsurance needs to be regulated by one regulator in the US.

continued on next page

continued from page 7

2. *Solvency of Cedents* — Any alternative system should maintain strong standards to protect the solvency of US ceding insurers.
3. *Pre-emption and Enforcement Authority* — A new reinsurance framework should identify the applicable jurisdiction and controlling regulator for the relevant reinsurance market, to ensure consistent application of reinsurance regulatory requirements. This will require pre-emption and enforcement authority at a central point to ensure that the authority of the single regulator is effective.
4. *Consistent Application of Rules* — A reinsurance regulatory framework should provide rules that can be applied uniformly and in a consistent manner. Reinsurance rules, when applied to similarly situated market participants, should produce comparable results.
5. *Efficiency and Effectiveness* — A reinsurance regulatory framework should promote efficiency and effectiveness.

A new system should promote a sound competitive and open insurance and reinsurance marketplace that avoids market distortions.

6. *Assessing Financial Strength of Reinsurers* — A mechanism should exist to efficiently and effectively assess the financial strength of reinsurers, whether those reinsurers are domiciled in the US or abroad.
7. *Regulatory Equivalence* — The system must provide for recognition of substantially equivalent regulatory standards and enforcement across competent regulatory jurisdictions.
8. *Balance* — Any system must reach a proper balance between goals that are in tension:
 - a. *Solvency Protection* — A reinsurance regulatory structure focused on assuring the solvency of reinsurers is appropriate. However, such a structure should be sufficiently flexible to foster deployment of capital to the reinsurance industry by competent competitors.
 - b. *Access to capital* — The regulatory environment should provide sufficient flexibility so

that reinsurers can attract capital from all reasonable sources. Conversely, the regulatory structure cannot be so lax as to permit entry by competitors that will not have the capacity and capabilities for sustained, successful business operations over the long periods required of reinsurers.

9. *Principles-Based Regulation* — The system should be based on the concept of principles-based, as opposed to rules-based, regulation.
10. *Global Capital and Risk Management* — A supervisory framework that supports global capital and risk management, taking into account capital adequacy, assessment of internal controls and effective corporate governance. Implicit in this principle is the recognition of qualifying economic capital models for US reinsurers, as well as non-US reinsurers.
11. *Evaluation of Assets and Liabilities on an Integrated Basis* — Evaluation of assets and liabilities should be carried out on an integrated basis when assessing the impact of risk factors on a firm's available and required economic capital.
12. *Assessment of Risk* — A reinsurance regulatory framework should encompass credit risk and all other risks.
13. *Assessing Risks on an Aggregate Basis* — Risks should be assessed on an aggregate basis, taking into account the relationships (correlations) between them, as opposed to assessing each risk on a stand-alone basis.
14. *Promote Sound, Competitive and Open Market* — A new system should promote a sound competitive and open insurance and reinsurance marketplace that avoids market distortions.
15. *Claims Payment* — Timely claims payment is a fundamental goal. An improved system should assess claims paying ability, including the enforcement of US judgments, as well as the reinsurer's willingness to abide by its contractual obligations.
16. *Access to Financial Information* — Supervisors should have access to all financial information, while protecting proprietary and confidential information.

continued on page 26

Think Tank

Regulatory Framework Revisited...

continued from page 8

17. *Financial Statement Transparency*—Appropriate reporting and disclosure of the reinsurer's financial condition, including information encompassing risk management and risk assessment practices.
18. *Preserve Insurer Choice*—The system should preserve the ability of US cedents to access reinsurance capacity by choosing to do business with either US or non-US reinsurers. It should preserve the rights of cedents and reinsurers to negotiate terms and conditions of contracts, including collateral where it might not otherwise be required.
19. *Applicability to all Participants and Transactions*—A reinsurance regulatory framework should address captives, pooling arrangements, fronting and intercompany reinsurance agreements.
20. *Transition*—There should be an effective transition mechanism between the current system and any medium term approach that is consistent with the Core Principles. Absent mutual agreement of the parties, any reduction in collateral requirements will only apply prospectively.

After identifying the Core Principles, the IPs considered options for potential regulatory frameworks and found that three were most consistent with those principles and standards:

- Single State Regulator (through federal law with a federal oversight function)
- National Vetting Agency
- Optional Federal Charter (OFC)

A brief overview of each of these structures is set forth below.

Single State Regulator

The following structure is modeled, in part, on the current European Union structure. It incorporates the concept of "single state" regulation with a Federal oversight function. This provides for a single regulatory body to promulgate laws and regulations governing the reinsurance industry, while allowing for continued state regulation. It is designed to retain the expertise of state regulators while ensuring uniformity.

This system would offer a certification procedure giving those states with resources, expertise and experience authority to regulate reinsurance as a "home state regulator." This regulator would have complete jurisdiction over its domestic reinsurers. Reinsurers supervised by certified home states would be able to offer reinsurance nationwide; ceding companies would be allowed to take credit for such reinsurance. The proposal also contemplates the creation of a mediation system to resolve disputes among insurance regulators regarding reinsurance issues. It also incorporates a federal enforcement mechanism to ensure that both "home states" and "host states" regulate in accordance with established laws, regulations and standards. Federal oversight and enforcement would reside in a newly established National Reinsurance Commission.

National Reinsurance Commission

The National Reinsurance Commission (NRC) would be established as an agency of the US Treasury Department, governed by the National Reinsurance Commissioner (the Reinsurance Commissioner) to serve for a five year term. The Reinsurance Commissioner would be a Presidential appointee requiring Senate confirmation. The duties of the NRC would include:

- Proposing new laws and regulations governing reinsurance regulation;
- Certifying state insurance departments as qualified home state reinsurance regulators pursuant to established standards;
- Overseeing state insurance departments to ensure that both home states and host states are regulating in accordance with established laws, regulations and standards and corresponding enforcement mechanisms for failure to do so;
- Establishing a complaint and dispute resolution process (with enforcement mechanisms) to resolve differences between interested persons and entities, which may include a mediation process to resolve issues among state insurance departments;
- Negotiating mutual recognition agreements with non-U.S. regulators pursuant to established standards; and
- Promoting regulatory and market practices and procedures that result in global financial

efficiencies while maintaining the security and soundness of the U.S. marketplace.

A federal legislative framework would be needed to establish the structure and the substance of such reinsurance regulation

Legislative Framework to Establish the Single Regulator Regulatory Framework

The new legislative framework would include enabling legislation to empower the regulatory authority to enact rules consistent with the legislation. Federal legislation would pre-empt inconsistent state statutes and regulations, including the ability of a state insurance department to refuse credit for reinsurance to a ceding insurer utilizing a qualified reinsurer, or from imposing contractual or other requirements upon that reinsurer other than those permitted by such new Federal law or NRC promulgated regulation.

Single U.S. Passport System

Reinsurers could opt for a certified state to act as their home state regulator. For the duration of the reinsurer's compliance with applicable laws and regulations of the home state, the reinsurer would be automatically authorized to do business in all other states (host states). Cross border business of reinsurers domiciled in jurisdictions outside the U.S. would be implemented through a port of entry of a certified home state regulator pursuant to mutual recognition agreements negotiated by the NRC.

National Vetting Agency

The National Vetting Agency (NVA) proposal is essentially an extension of the Single State Regulator proposal. It adds a federal oversight entity (the US Reinsurance Agency) to qualify or certify ("vet") assuming insurers and/or jurisdictions' reinsurance regulation.

A new federal law would create a new agency in the US Treasury Department charged with three types of responsibilities related to reinsurance:

- Certification of US state insurance departments as qualified home state regulators pursuant to standards that the law establishes;
- Certification of non-US jurisdictions as "competent," pursuant to the same standards; and
- Licensing reinsurers and insurers to conduct a

reinsurance business nationally, also pursuant to standards established in the law.

An insurer wishing to assume reinsurance could choose any one of those ways to operate in the US.

The National Vetting Agency would have the responsibility to:

- Propose national laws and regulations governing reinsurance;
- Establish minimum standards and capabilities necessary for a jurisdiction to be certified as a reinsurance regulator;
- Certify U.S. and non-U.S. jurisdictions as being qualified reinsurance regulators;
- Articulate and maintain standards for determining if an assuming insurer is qualified to be licensed to conduct a reinsurance business nationally;
- Manage a complaint and dispute resolution process;
- Negotiate mutual recognition with non-U.S. jurisdictions; and
- Promote an efficient reinsurance regulatory environment.

A federal legislative framework would also be required to establish the NVA.

Legislative Framework to Establish the National Vetting Agency

The legislative framework would articulate the structural and substantive parameters to enable the NVA to fulfill its responsibilities. Federal legislation would pre-empt the ability of a state insurance department to refuse credit for reinsurance to a ceding insurer utilizing a qualified reinsurer or from imposing contractual or other requirements upon that reinsurer other than those permitted by Federal law or regulation.

Optional Federal Charter

This legislative option would permit insurers assuming reinsurance to become federally chartered. It would also permit state-chartered insurers to become federally licensed to assume reinsurance. Insurers assuming reinsurance with a federal charter or a federal license would operate pursuant to federal standards. State supervision of federally chartered

continued on next page

Think Tank**Regulatory Framework Revisited...**

continued from previous page

or federally licensed assuming insurers would be pre-empted. A National Reinsurance Office led by a Federal Reinsurance Commissioner would be authorized to promulgate rules based on principles that would protect public interest in providing secure and sufficient reinsurance capacity in the US and promote effective and fair competition for US reinsurers doing business nationally and internationally.

National Reinsurance Office

The National Reinsurance Office and the position of Commissioner of Reinsurance would be created within the US Department of Treasury. The Office and the Commissioner's powers would be patterned after the Office of Thrift Supervision and its Director. The Commissioner's position would be a Presidential appointment with a five-year term. The Office would be funded with assessments on federally chartered and federally licensed assuming insurers. The Commissioner's duties would include:

- Regulating charter conversions;
- Establishing licensing, accounting, auditing, and corporate governance standards;
- Examining federally chartered and federally licensed assuming insurers for solvency;

- Approving the establishment of a self-regulatory organization;
- Negotiating mutual recognition agreements with non-US regulators; and
- Assuring fair and effective competition.

Legislative Framework for National Insurance Regulator

The Optional Federal Charter establishing the new framework would preempt the authority of a state insurance department to:

- Refuse credit for reinsurance to an insurer ceding to a federally chartered or federally licensed insurer;
- Impose contractual or other requirements on reinsurance agreements with federally chartered or federally licensed assuming insurers; or
- Examine the solvency of a federally chartered assuming insurer.

The law would also prohibit states from discriminating against federally chartered insurers, federally licensed insurers, or any parties to reinsurance agreements with them.

We look forward to the evolution of these important initiatives. ■

Feature Article**Starting a New Chapter...**

continued from page 21

would not have occurred in the classic case of a traditional non-US company seeking ancillary assistance for its US-type insolvency or reorganisation proceeding. Applying Chapter 15, and the rules promulgated for its implementation, to the intricacies of the MMA Account situation unearthed numerous ambiguities in the new law as well as aspects of it not clearly apparent. Through that process, challenges and opportunities, particularly for insurance and reinsurance run-off scheme proponents, became apparent, and mechanisms for their resolution and optimisation were devised. The success of future attempts to aid run-off schemes through Chapter

15 likely will depend in great part on the manner in which the particular circumstances of the scheme and its process are woven into the many corners of Chapter 15 and ultimately presented to the US court. ■

Notes

- ¹ Chapter 15 of the US Bankruptcy Code replaces, and significantly expands beyond, former section 304 of the code, to which proponents of UK schemes of arrangement have looked to obtain relief from US courts in aid of the implementation of the scheme, including through issuance of injunctions against the taking of actions against the debtor or its assets within the US. Readers of Global Reinsurance are familiar with recent challenges to solvent schemes presented by, now, old US section 304. See, eg, Melnik, "Help from the US?"; *Global Reinsurance*, March 2005.