INTERIM REPORT OF THE INTERESTED PERSONS[1] TO THE NAIC REINSURANCE TASK FORCE JUNE 10, 2006

Introduction

The Reinsurance (E) Task Force offered the Industry Interested Persons (IPs) the opportunity to respond to the following charge:

> ***Charge from the NAIC Joint Executive (EX) Committee and Plenary Meeting of March 5, 2006 to the Reinsurance (E) Task Force:*** The Reinsurance (E) Task Force is directed to develop alternatives to the current reinsurance regulatory framework, including the use of collateral within the U.S. and abroad. Consider approaches that account for a reinsurers financial strength regardless of domicile, i.e., state or country. Identify and consider variations in state law and regulation relative to reinsurance contracts, financial reporting, etc. As part of its deliberations, the Task Force should consult with international regulators in addition to all other interested parties. The Task Force shall present the proposal to the membership by the December 2006 national meeting.

To assist the Task Force in its work, the Interested Persons group considered the functions of reinsurance as set forth in the US Reinsurance Collateral White Paper:

1. expanding insurance company capacity,
2. stabilizing underwriting results,
3. financing,
4. providing catastrophe protection,
5. withdrawing from a line or class of business, and
6. spreading of risk.

In light of a number of changes in the insurance and reinsurance marketplace, there is an interest by some participants in re-evaluating the regulatory framework for reinsurance. Among these market changes are:

- Globalization- as noted in the NAIC US Reinsurance Collateral White Paper, "Reinsurance Market Analysis" section, "The [Standard and Poor's Global Reinsurance Highlights Report] 2005 edition identifies the top 40 global reinsurance groups as measured by net reinsurance premiums written. While this report underscores the international nature of the reinsurance market, it also illustrates the small number of wholly owned U.S. reinsurance corporations. Since 33 of the top 40 reinsurance groups are domiciled outside the U.S., it stands to reason that a large market share is held by non-U.S. reinsurers (directly or ultimately controlled through off-shore parent corporations). "

- Increased cross-border reinsurance- The NAIC US Reinsurance Collateral White Paper "Reinsurance Market Analysis" section notes that, "unaffiliated premiums [i.e., ceded to unaffiliated reinsurers] have increased at an average annual rate of 8.2% (on a compounded basis)

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[1] Participation in the IP group by any party does not necessarily constitute support for any proposal or recommendation set forth by the group. All parties participating in the IP group retain full rights to oppose or object to any proposal or recommendation offered by the group. All parties retain the right to support alternate proposals or recommendations not offered or accepted by the group and/or retention of the current laws and regulations.

over the last 5 years while the affiliated premiums have increased at a 26.5% rate over that same time period primarily due to the increase of affiliated business being ceded to parent companies in Bermuda and Europe." This trend suggests that the most efficient regulatory structure would involve harmonization among regulatory systems equipped to address cross-border reinsurance transactions.

- Significant advancement toward the development of international accounting standards that should result in increased transparency.

- Concrete steps toward regional regulatory harmonization – e.g., EU Reinsurance Directive.

A number of state insurance regulators have acknowledged that in light of the evolving international market place, it is appropriate at this time to consider the question of whether a different type of regulatory framework for reinsurance in the US is warranted. The IP group believes that a reinsurance regulatory framework must be sufficiently flexible to accommodate the rapidly changing reinsurance environment while providing for appropriate levels of financial stability, solvency and predictability that are critical to a robust market and a strong and secure insurance regulatory system. Only in that way can the protection of underlying policyholders be assured.

During a series of meetings, the IP group developed:

- a statement of principles that would serve as a basis for the design and implementation of a new reinsurance regulatory framework;

- a proposed reinsurance regulatory structure based on those principles, and

- specific incremental approaches, with pros and cons of each, that might result in reduced or eliminated collateral requirements.

Further work is necessary, particularly with respect to the incremental approaches, to develop these ideas fully and to provide the detail required for potential implementation in the event that any of the approaches are adopted by the NAIC.

Additionally, the IPs reviewed the concerns about the recognition and enforceability of US judgments abroad and considered the impact that The Hague Convention (Convention) would have assuming ratification of the Convention.

Each of these areas is discussed in this report.

PARTICIPATION/PROCESS

Included as attachment A to this Interim Report is a list of the full IP group. Participation is open to any industry representative. In light of the fact that there are more than 100 participants, the chairs determined that the most efficient way to address the above-referenced charge was to establish three working groups. The chairs requested that the working groups be kept to a manageable size but did not, in fact, turn down any participant that asked to be on a working group. The three working groups are as follows, with the participants on each group listed in Attachment B:

- Regulatory Framework – The purpose of this working group was to review the NAIC charge and consider potential changes to the structural framework with respect to reinsurance regulation.
- P/C Collateral (also known as P/C Financial Criteria) – The purpose of this working group was to review potential incremental options for the reduction/elimination of collateral requirements.
- L/H Collateral (also known as L/H Financial Criteria) – The purpose of this working group was the same as the p/c group but with a life/health focus.

Additionally, with the assistance of DLA Piper, an e-room was established and every participant on the full IP group was given an individual password to access the e-room where the documents from the working groups and resource materials have been posted, in an effort to provide all participants with the ability to monitor the progress of the working groups.

April Meetings: A one and a half day meeting was held in Washington D.C. on April 18-19, 2006, in which approximately 33 working group participants attended. Approximately 2/3 of these were p/c and 1/3 were life industry representatives. Approximately ½ were reinsurance reinsurance company representatives for both p/c and life, ¼ were primary company representatives and about ¼ were employed with law firms.

May Meetings: Another one and a half day meeting was held in Washington D.C. on May 2-3, 2006, in which approximately 34 working group participants attended. The break down of participants was in the same approximate percentages as noted for the April meetings.

On May 22, 2006, a four hour meeting was held in New York for the full IP group with approximately 50 participants. A final conference call of the full IP group was held on June 2, 2006, to finalize the report with approximately 39 participants.

In addition to these meetings, a number of other conference calls and drafting group sessions were held.

REGULATORY FRAMEWORK

Participants from the three working groups discussed potential changes to the structural framework for reinsurance regulation. This discussion led to the creation of core principles which were submitted to the Reinsurance Task Force prior to the May 10, 2006 interim conference call. A group of primary insurers also submitted guiding principles. The IPs and primary insurer group were asked to review one another's submissions prior to the June 10, 2006 meeting for the purpose of blending them, where possible.

The IPs did this and the resulting Core Principles of the IPs is set forth below. All of the guiding principles from the primary insurer group have been incorporated except one. That guiding principle states "A reinsurance regulatory framework should focus on protecting the interests of ceding insurers, their policyholders, employees and third-party claimants." The IP group opted instead for the "balance" reflected in principles #8 below.

CORE PRINCIPLES AND STANDARDS
for an Alternative US Reinsurance Regulatory Framework
submitted by the Interested Persons to the NAIC Reinsurance Task Force
June 2, 2006

1. *Single Regulator for Reinsurance* -- The complexity and global nature of the reinsurance market requires that the direct and indirect supervision of reinsurance be regulated in a manner so that no reinsurer or reinsurance transaction is regulated by more than one regulator in the US.

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 reinsurance framework should identify the applicable jurisdiction and controlling regulator for the relevant reinsurance market, to ensure consistent application of reinsurance regulatory requirements. There must be pre-emption and enforcement authority at a central point to ensure that the authority of the single regulator is given effect.

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.

6. *Assessing Financial Strength of Reinsurers* -- There should be a mechanism 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* – Having a regulatory structure in the reinsurance business environment that is focused on assuring the solvency of reinsurers is appropriate. Overemphasis on this goal can result in a business environment that is so rigid that it forces out competent competitors (e.g., regulatory burdens make it costly that the capital can be deployed more effectively in other endeavors.

   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 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, including a move toward implementation of a system that encompasses this approach in the US.

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 not only take credit risk into account, but should also address all risks.

13. *Assessing Risks on an Aggregate Basis* -- Risks should be assessed on an aggregated 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 which avoids market distortions.

15. *Claims Payment* – Timely claims payment is a fundamental goal and 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 and must recognize that some such information may be proprietary and must remain confidential.

17. *Financial Statement Transparency* – Appropriate reporting and disclosure of the reinsurer's financial condition including information encompassing risk management and risk assessment practices.

15. *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.

16. *Applicability to all Participants and Transactions* – A reinsurance regulatory framework should address captives, pooling arrangements, fronting and intercompany reinsurance agreements.

17. *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.

The participants reviewed potential regulatory frameworks in light of these core principles. That review included the following structures:

- Expansion of the Risk Retention Act to include reinsurance
- Optional Federal Charter (OFC)
- Federal regulation other than OFC (a "federal vetting system")
- Single state regulator (through federal law with a federal oversight function or through interstate compact)
- Self-regulation

Ultimately, the IPs focused on the following three potential structures as being most responsive to the core principles:

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

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 point for establishment of laws and regulations governing the reinsurance industry coupled with state regulation of the reinsurance transaction. It retains the expertise of state regulators while ensuring uniformity.

The proposal contemplates establishment of a certification mechanism so that those states that have the resources, expertise and experience to regulate reinsurance can do so as a "home state regulator" which will have complete jurisdiction over its domestic reinsurers. Reinsurers supervised by certified home states would be able to provide reinsurance nationwide and 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.. And, it incorporates an enforcement mechanism to ensure that both "home states" and "host states" regulate in accordance with established laws, regulations and standards.

National Reinsurance Commission

The National Reinsurance Commission (NRC) is created as an agency of Treasury, governed by the National Reinsurance Commissioner which shall be a Presidential appointment with Senate confirmation. The Commissioner shall have a term of 5 years. The duties of the NRC shall include:

- Propose new laws and regulations governing reinsurance regulation;
- Certify state insurance departments as qualified home state reinsurance regulators pursuant to established standards;
- Oversight of 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;
- Establish a complaint and dispute resolution process to resolve differences between interested persons and entities, which may include a mediation process to resolve issues among state insurance departments;
- Negotiate mutual recognition agreements with non-U.S. regulators pursuant to established standards; and
- Promote regulatory and market practices and procedures that result in global financial efficiencies while maintaining the security and soundness of the U.S. marketplace.

Legislative Framework
The laws establishing both the structure and the substance of reinsurance regulation would be set out in the enabling legislation with a traditional authorization 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 Federal law or regulation.

Single U.S. Passport System
Reinsurers would have a choice as to which certified state would act as their home state regulator and as long as the reinsurer complies with applicable laws and regulations of the home state, it can automatically do business in all other states (host states). Cross border business of reinsurers domiciled in jurisdictions outside the U.S. would be effected 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 proposal is, for the most part, 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.

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

- Certify US state insurance departments as qualified home state regulators pursuant to standards that the law establishes;
- Certify non-US jurisdictions as "competent," pursuant to the same standards; and
- License 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, under uniform national regulation.

The US Reinsurance Agency would have responsibilities 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 jurisdictions as being qualified reinsurance regulators,
- elaborate 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.

Legislative Framework
The laws establishing both the structure and the substance of reinsurance regulation would be set out in the legislation to a large extent. 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 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 or federally licensed assuming insurers would be preempted. The federal reinsurance commissioner would be authorized to promulgate rules, directed to give due consideration to the public interest in providing secure and sufficient reinsurance capacity in the US and to the need for promoting effective and fair competition, and charged with promoting the international competitiveness of US reinsurers.

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 supervisors; and
- Assuring fair and effective competition.

Legislative Framework

The law 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 charted insurers, federally licensed insurers, or any parties to reinsurance agreements with them.

INCREMENTAL OPTIONS FOR REDUCTION/ELIMINATION OF COLLATERAL

As noted above, the IPs considered incremental options to the reduction/elimination of collateral requirements. While there was no consensus on these approaches, there is support among various participants for certain of the options. There is also opposition to certain of the options by various participants, and in some cases, any option that would result in reduction of collateral.

Nevertheless, the IPs were able to develop a set of pros and cons to each incremental approach. The detail of these options, and additional pros and cons, need to be more fully developed prior to the September 2006 NAIC meeting.

Introductory Comments Applicable to All Incremental Options

In addition to considering comprehensive reform of U.S. reinsurance regulation, the Reinsurance Task Force has asked the Interested Persons to also consider interim modifications to the current collateral requirements. The IPs have discussed several options which are set forth below. For each option we have listed some of the unique "pros" and "cons" which were identified for each. These lists of pros and cons are not exhaustive. In addition, it should be noted that all of these incremental approaches have some common pros and cons. These include:

Pro --

1. Incremental steps would permit regulators to field test in a more limited manner, modifications to the current 100% collateral requirements. This may ease the transition to an alternative regulatory regime.
2. Partial reduction in collateral should encourage some ceding companies, where necessary, to improve their credit assessment capabilities.
3. Meaningful interim steps may begin a process toward change and indicate to many who are interested in this issue that the U.S. is committed to modernizing its regulatory approach, including its credit for reinsurance rules.

Con --

1. Modifying collateral requirements will reduce or eliminate security for the affected reinsurance contracts.
2. Cedents may experience greater levels of uncollectible reinsurance. Problems with respect to collectibility can happen in the current environment if the collateral is insufficient in relation to the liabilities. However, this could be exacerbated if there was a lower collateral base at the outset.
3. Depending on the nature of the incremental option, implementation may require amendments to state credit for reinsurance laws or regulations. This will require some effort, and may not be successful in a 50-plus state system.
4. The focus and effort needed to implement statutory and regulatory changes to collateral requirements may distract regulators, industry and legislators from the comprehensive reform of reinsurance regulation, which many believe is the most important objective.

The IPs did not consider the affect of incremental options in relation to reinsurance transactions involving captives, fronting and intercompany pooling transactions. These reinsurance transactions have some unique characteristics that require further work.

Generally speaking, there have been discussions about applying incremental options to retrocessions even if not to direct cessions. The following reflects rationale for that approach:

- The treatment of retrocessions can be distinguished from cessions of primary insurers for a number of reasons, e.g. the characteristics of the cedent; the fact that US regulators have no control over the retrocessions of non-US reinsurers or retrocessionaires and therefore, the “chain” of review does not extend to these additional levels anyway; the fact that reinsurance recoveries from retrocessionaires are assets of the retrocedent but are not, in any case, assets of the primary ceding company.

- One concern often expressed by US primary insurers is that while some large insurers believe they have the sophistication and leverage to demand collateral protection contractually and the ability to assess the creditworthiness of their counterparties, they do not necessarily believe their small to mid-size competitors have those options or abilities. This potentially adversely affects the guaranty fund assessments that the large insurers are required to pay. Reinsurers are able to assess the creditworthiness of their counterparties and their failure to do so does not necessarily affect guaranty fund assessments.

The following incremental options and commentary were discussed by the Interested Persons, though there is no consensus among the IPs for any particular incremental option or the adoption of any incremental option whatsoever.

Generally, the Interested Persons observe that each option listed below would be most effective if implemented through changes to the model law and/or model regulation on credit for reinsurance and parallel changes to states' laws and regulations. Although there is no consensus on these points, it has been suggested that modifications could be made, without changes to applicable laws or regulations, by (1) changing the terms of multiple-beneficiary trusts to permit deferred funding (which Lloyd's has done with regulatory approval), and (2) using the reference in the current model law to "other acceptable security" to allow for modifications.

It was noted that indicia of financial strength does not account for the willingness of a reinsurer to pay, as evidenced by overdue amounts/disputes reflected on US cedents' Schedule F. Some have suggested that the following approaches might incorporate a penalty for "slow-pay" reinsurers. Each might also incorporate some penalty or other incentive for brokers that do not remit promptly. Additionally, some believe that receivers should be required to maintain a Schedule F to readily identify those reinsurers with whom reinsurance recoverables are problematic.

It should be recognized that certain approaches benefit certain market participants and not others. Therefore, it might be appropriate to consider a combination of approaches.

Incremental Options Discussed To Date

Short Term Catastrophic Property Risks (deferred funding)

This option would permit a deferral in funding though the 100% funding requirement would still apply. The definition of a triggering catastrophe event should be high so that the deferral is only triggered under fairly severe circumstances. The extended funding period applies only to liabilities related to the catastrophic event(s), all other assumed liabilities would be funded in the regular course. Use of the provision would be subject to the discretion and oversight of the US insurance regulator that is the domestic regulator for purposes of overseeing the collateral.

Pro --

- This option is in use currently (*e.g.,* current 90 day deferral for Lloyd's trust fund when certain triggers are met).
- In a catastrophe situation deferred funding for a limited period of time for short tail losses does not have a significant adverse impact on ceding insurers since it takes time even for short tail losses to work their way through the pipeline.
- It provides additional time to manage assets and avoids "fire sale" of assets following a catastrophic event.
- Proponents believe that It may not require change in model law or regulation (or state laws) with respect to multiple-beneficiary trusts.
- Parties can contract otherwise.
- Despite unprecedented catastrophe losses in recent years, reinsurers have an excellent track record for payment of claims so limited deferred funding should not be the basis for heightened concerns.

Con --

- Rating agencies analyze only year-end results, so, depending on the timing, absence of the collateral at year-end could affect their view of cedents' financial ratings and management of credit risk.
- Deferred funding could delay recognition of the fact that the reinsurer may be unable to pay the claims or has insufficient liquid assets to meet its contractual obligations. Others note that this reflects the importance of the involvement of the US regulator supervising the collateral requirements.
- Cedents are concerned that funding that is not be immediately available may prove to be inadequate when the deferral period has lapsed. Others note, however, that the effect of the deferred funding is to facilitate the flow of reinsurance proceeds directly to ceding insurers rather than diverting those funds into a multiple-beneficiary trust to be available on a standby basis.
- This option might not be workable under current laws for agreements secured with single beneficiary trusts or letters of credit because cedents' reserve credit is currently limited to the amount of collateral in place as of the statement date.
- This option may provide different treatment for unauthorized reinsurers (depending on whether they fund a multiple-beneficiary or single beneficiary device) without a philosophical basis for doing so.

Short Term Property Liabilities, including cat risks (reduced/eliminated funding)

This approach would be based upon criteria relating to the financial strength of the reinsurer.

Pro --

- If the risk is one with a short tail then buyers may have more confidence in the credit rating of the reinsurer.
- Reduction might be triggered when a market becomes constrained, thereby triggering potential expansion of capacity (though not all agree that reducing collateral expands capacity).
- This option could be an incremental step toward placing more reliance on counter party credit risk as a means of assessing future collateral alternatives.
- Despite unprecedented catastrophe losses in recent years, reinsurers have an excellent track record for payment of claims.

Con --

- It is unclear what constitutes “short tail” property risk (e.g., what lines of business in addition to catastrophe exposure, how does one break out property from casualty where multiple lines of business are covered in the same policy).
- Primary capacity could be adversely effected if collateral is reduced or eliminated because insurers might not be willing to write as much property business without the collateral.
- Even if reducing collateral did create more capacity, there is no guarantee that the additional capacity would be deployed in the United States market.

Additional Comments:

- There is a qualitative difference between routine property and catastrophic exposure, the first being less volatile and less subject to accumulation. Because a catastrophic event can lead to solvency-threatening exposure, reduced or eliminated collateral might be appropriate for routine property liabilities but not for catastrophic events.

Qualifying Cessions and Retrocessions to Affiliates

Credit for reinsurance may be granted with reduced or eliminated collateral, subject to domestic regulatory discretion. This option would require consideration of amending holding company laws to ensure that uncollateralized affiliate transactions are not found to be in violation of the “fair and reasonable” standard by virtue of the lack of collateral. It is noted that holding company laws currently incorporate a credit worthiness analysis; however, more discussion needs to take place on this point. Further consideration needs to be given to the appropriate definition of “affiliate” to determine whether the holding company definition, or some other definition, should be used.

Pro --

- Affiliate transactions are subject to regulatory review under state holding company laws. That review provides a higher standard of regulatory scrutiny by subjecting the transaction not only to the typical risk transfer and other requirements imposed on unaffiliated reinsurance transactions, but to a standard that requires that the transaction be fair and reasonable, result in surplus that is reasonable in relationship to liabilities, etc.
- The investment of substantial capital in the US licensee represents a real commitment of the unlicensed entity to the US market. The value of that asset may be subject to attachment by US regulators upon established statutory grounds.
- Although unlicensed, the affiliate reinsurer has subjected itself to a substantial degree of US regulatory scrutiny pursuant to the applicable holding company system act, both at the time of acquisition and on an ongoing basis.
- All material affiliate reinsurance contracts must be submitted to the US licensee’s domestic regulator for <u>prior approval</u> which approval can be subject to regulatory conditions including, presumably, collateral sufficient to satisfy regulatory concerns.
- Violation of the applicable holding company act requirements may result in substantial penalties, including criminal penalties in the case of willful violations.
- Holding company laws require the submission of substantial information about the entire holding company system and the controlling entity. This allows regulators to better understand the impact and fairness of the transaction rather than simply reviewing the contract itself.
- The likelihood of a contentious relationship developing between affiliated parties is considered less than that with unaffiliated parties, thereby reducing the probability of disputes regarding reinsurance recoverables.
- Permitting affiliate transactions to be uncollateralized follows the direction of international regulatory efforts focused on greater recognition of and reliance on group supervision and flexibility in allowing groups to better manage their global risks and capital management.
- This option applies equally to property/casualty and life transactions.

Con --

- It was noted that there could be potential abuses through fronting. If this incremental option is pursued by regulators, further consideration needs to be given to this concern. However, others believe that sufficient safeguards are already provided in the holding company laws, as noted in the "pro" section, which would prevent such abuses.

Qualifying Cessions to Non-US Entities that Retrocede to US Entities
This option would permit reduced or eliminated collateral for cessions to non-US reinsurers that retrocede back to US retrocessionaires. This option could be made available only to strong retrocedents ceding to strong US retrocessionaires.

Pro --

- This option may benefit the market because sophisticated entities will be analyzing counter-party credit worthiness.

Con --

- Distinguishable from affiliate transactions because the funds go offshore to an unaffiliated entity before coming back to the US. Without an effective cut-through there is no increased security for the US cedent by virtue of the retrocessionaire being a US entity.

Additional Comments:

- Upon the insolvency of a non-US reinsurer, funds should come back to the US rather than remaining abroad subject to the insolvency laws of the foreign country.

Working Trusts
Substantial work has previously been done on this approach.

Pro --

- Some cedents and some reinsurers support this concept

Con --

- Some cedents do not support the concept, and some reinsurers do not believe it addresses their concerns

Weighted Financial Strength Rating Based on Rating Agency Designation
This approach would recognize the financial strength of reinsurers based on a sliding scale of collateral *(* between 50 and 100 percent) using the financial strength ratings of the reinsurer as determined by rating agencies.

Pro --

- The financial strength of each reinsurer would be analyzed (*e.g.*, risk-adjusted approach)
- Reinsurers would post collateral based on their financial strength rather than a "one size fits all" approach.
- Cedents would have responsibility for the choices they make in terms of counter parties.
- This approach recognizes that there are issues other than financial strength that need to be addressed in any comprehensive approach, such as enforceability and diversification. Nevertheless, it provides a relatively straight-forward assessment of financial strength which lends itself to an incremental step while providing substantial security in that interim period.

Con --

- Analysis would have to be ongoing and continuous requiring the reinsured/broker follow the rating changes and in the event of a rating downgrade, require collateral increases at a difficult time for the reinsurer.
- There was opposition to relying on rating agency designation including the subjectivity of their ratings and the lack of accountability or oversight of their determinations
- Although some point to the reliance on ratings for investments as precedent in this area, there are additional limitations on investments, e.g., statutory asset limitations, RBC charges, junk bond limitations, valuation method for p/c side. This is not the case with reinsurance which does not have an available re-sale market.

Additional Comments:

- This could result in increased security from some market participants.

Weighted Financial Strength Rating Based on Financial Indicators

This approach would provide a sliding scale of collateral requirements based on a reinsurer's financial strength utilizing financial indicators as opposed to relying solely on rating agency designations.

Pro --

- The financial strength of each reinsurer would be analyzed (*e.g.*, risk-adjusted approach).
- Reinsurers would post collateral based on their financial strength rather than a "one size fits all" approach.
- Cedents would have responsibility for the choices they make in terms of counter parties.
- A sliding scale of financial strength would be based on financial indicators.

Con --

- It might be difficult to determine financial strength using various, different accounting systems.
- Who would perform the analysis if not rating agencies?

Additional Comments:

- This could result in increased security from some market participants.

Pooling Proposal

This proposal, as previously submitted to the NAIC, would provide, in effect, a guaranty fund for ceding insurers.

Pro --

- Those who benefit from the system have to have "skin in the game."
- Provides non-US reinsurers another option (subject to US regulated, provide collateral or obtain relief from collateral in exchange for participation in the pool).

Con --

- Non-US reinsurers will not apply to be on the "white list." The benefit received would be minimal compared to the downside of joint and several liability.
- Cedents may be able to recover some of the costs of insolvencies. Presumably, reinsurers subject to the pool would pass the costs onto their cedents.
- As proposed, a failure of a non-US reinsurer to make a payment would result in a ceding insurer gaining access to the pool. Such access is thus not limited to the insolvency of a reinsurer.
- If the underlying problem is small insurers making poor reinsurance-buying decisions, then regulators should address that problem rather than cost-shifting to reinsurers.
- Guaranty associations were established to protect consumers that are unsophisticated and not educated in the complexities of insurance. That is not the case with ceding insurance companies.
- The concept of a primary insurer guaranty fund is contrary to even the current philosophies applied in the guaranty fund world because consumers with a large net worth are typically not the recipients of guaranty fund coverage.

Other Incremental Approaches

Other approaches have been identified by the Interested Persons. However, there has been insufficient time to develop the pros and cons for those approaches. Further discussions will take place.

Unearned Premium Reserves

To be discussed and developed later.

- Philosophically issues are similar to short term property issues but conceivably could be longer term.

Special Considerations

It has been suggested that in the event that one or more incremental options for collateral reduction/elimination is adopted, the following measures could be considered.

Guaranty Fund System
Reinsurer participation in existing guaranty funds.

Pro --

- Those who benefit from collateral reduction should have "skin in the game."

Con --

- It is not clear whether such a requirement should apply to reinsurers licensed or accredited in the US. although only non US reinsurers would benefit from collateral reduction.
- Cedents may be able to recover some of the costs of insolvencies. The various methods by which this is accomplished could make any allocation between insurers and reinsurers for purposes of recouping guaranty fund assessments unworkable.
- The costs of guaranty fund and other business costs are negotiated between the insurer and reinsurer as part of the ceding commission, therefore, the suggestion that reinsurers do not contribute to the current system is misplaced.
- If the underlying problem is small insurers making poor reinsurance-buying decisions, then regulators should address that problem rather than cost-shifting to reinsurers.
- The US has no jurisdiction over non-US entities to enforce their contribution to the guaranty fund system.
- Any attempt to impose guaranty fund requirements on reinsurers would reduce reinsurance capacity to the US market.

Funding When an Insurer Goes Into Run-off/Receivership
To be discussed and developed later.

Impact of the Hague Convention on Choice of Court Agreements on the Enforceability of Judgments Entered Against Non-US Reinsurers[2]

BACKGROUND:

The enforceability of judgments against non-US reinsurers has become a focal point for the debate on requested changes to the collateral security requirements in the NAIC's Credit for Reinsurance Model Act and Credit for Reinsurance Model Regulation. Opponents of change contend that judgments against non-US reinsurers are not certain to be enforced, while proponents assert that judgments entered by courts of competent jurisdiction are enforceable under most circumstances.

The Twentieth Session of The Hague Conference on Private International Law (the "Hague") recently adopted a new Convention on Choice of Court Agreements ("Convention") that, if ratified, may ensure enforceability. The Convention is the product of the concerted efforts of a Hague Special Commission on Jurisdiction, Recognition and Enforcement of Foreign Judgments in Civil and Commercial Matters (the "Special Commission"). A final report of its deliberations is expected in the near future, following which the Convention will be available for ratification by the 45 Hague member states.

[2] It was suggested by some IP members that copies of the industry concerns abut enforceability be appended to this Interim Report. The Chairs declined to do so as those documents have previously been submitted to the Task Force and there was no need to do so again here, adding to the length of an already substantial report. The Task Force should be aware of those documents and may choose to consult them.

The Convention is designed to ensure the recognition and enforcement of court-made judgments entered in civil disputes between parties to commercial contracts who have chosen one or more courts of a State for the resolution of their contractual disputes. Only the chosen court could enforce such a judgment, with very limited power of review on either substantive or procedural grounds. The Convention thus would complement the benefits and protections accorded to arbitral awards and judgments of confirmation entered in insurance and reinsurance disputes pursuant to various other treaties and statutes already in force (such as the Federal Arbitration Act ("FAA"), 9 U.S.C. §§ 1-16; Convention on the Recognition and Enforcement of Foreign Arbitral Awards, implemented in the U.S. as Chapter 2 of the FAA, 9 U.S.C. §§ 201-208; and Inter-American Convention on International Commercial Arbitration," implemented in the U.S. as Chapter 3 of the FAA, 9 U.S.C. §§ 301-307; *see also* the Foreign Sovereign Immunities Act ("FSIA"), 28 U.S.C. § 1602-1611).

The Convention does not encompass disputes concerning a wide variety of matters that insurance and reinsurance agreements are specifically designed to cover. For example, the Convention does not cover matters of tort claims for damage to tangible property; claims for personal injury; insolvency; carriage of passengers and goods, marine pollution; liability for nuclear damage; decisions of legal persons (entities); infringement of intellectual property; and the validity of entries in public registers. (Art. 2, ¶ 2.) It also does not apply to non-compensatory (*e.g.*, punitive or exemplary) damages. (Art. 11, ¶ 1.) For these reasons, the NAIC (by resolution), the International Association of Insurance Supervisors ("IAIS") (by letter) and certain US and European insurance market representatives and trade organizations encouraged the Hague to adopt changes to ensure application of the Convention to insurance/reinsurance judgments.

The Hague delegates listened to the NAIC, IAIS and the industry and responded positively. Article 17 of the Convention provides:

> *Article 17 Contracts of insurance and reinsurance*
>
> 1. Proceedings under a contract of insurance or reinsurance are not excluded from the scope of this Convention on the ground that the contract of insurance or reinsurance relates to a matter to which this Convention does not apply.
>
> 2. Recognition and enforcement of a judgment in respect of liability under the terms of a contract of insurance or reinsurance may not be limited or refused on the ground that the liability under that contract includes liability to indemnify the insured or reinsured in respect of –
>
> *a)* a matter to which this Convention does not apply; or
>
> *b)* an award of damages to which Article 11 might apply.

In the course of preparation of the U.S. Reinsurance Collateral White Paper, members of the US insurance industry identified six inter-related concerns about the enforceability of judgments against non-US reinsurers under the Convention: (i) due process/notice, (ii) default judgments, (iii) public policy in respect of (a) US state pre-answer security statutes and (b) certain state prohibitions on the (re)insurability of punitive/non-compensatory damages, (iv) insolvency, and (v) member state exceptions ("declarations" in the Convention). The IPs addressed these issues at their meetings on February 1 and May 22, 2006.

The IPs note that the Convention enjoys a wide base of support, due in no small measure to the efforts and support of the Task Force and the coordinated and dedicated efforts of many Interested Parties. The IPs concur that it should be ratified by the U.S. Senate and both industry and regulators should register their support through appropriate channels. The IPs note that the Convention cannot ensure that there will not be any challenges made to the enforcement of judgments against non-US reinsurers, and that it is important for regulators, receivers and members of the international insurance/reinsurance industry and the legal community to inform themselves about all applicable requirements to ensure that the Convention serves its intended purpose.

A summary of the IPs' discussions and conclusions follows.

ISSUES AND CONCLUSIONS:

1. Due Process/Notice

The Convention reflects current law in U.S. and non-U.S. jurisdictions. If a foreign defendant is not notified in accordance with the fundamental principles of due process of the "requested state" (where the judgment is brought for recognition or enforcement) and does not appear or contest notification in the chosen U.S. court of origin, the foreign court may refuse to recognize or enforce the U.S. judgment. For example, in civil law countries, as in the U.S., due process protections assure that the appropriate notice is provided to the defendant through compliance with service of process formalities. Where the prescribed formal procedures are not followed by insurers (or their receivers) in the course of collecting reinsurance proceeds from foreign reinsurers, non-US courts may refuse enforcement of the resulting judgments.

Conclusion:
When contracting parties choose a designated court to recognize and enforce judgments entered between them, they may and effectively do choose the law governing notice and service of process. U.S. parties need to educate themselves about the applicable requirements. (Parties may wish to consult, *e.g.*, the procedures outlined in the Hague Convention of 15 November 1965 on the Service Abroad of Judicial and Extrajudicial Documents in Civil or Commercial Matters; *see also* Council Regulation (EC) No 1348/2000 of 29 May 2000 on the service in the European Community Member States of judicial and extrajudicial documents in civil or commercial matters, O.J. L 160, p. 37.) Regulators and ceding companies will not want to rely exclusively on local statutory provisions regarding notice and service or on related contractual provisions, as there may be a question whether parties can effectively waive by pre-service contract or agreement their domestic constitutional or fundamental due process protections.

2. Default Judgments
By definition, the Convention applies to judgments decided "on the merits" of the case. Many jurisdictions in the U.S. regard default judgments as having been decided "on the merits." A few published court decisions entered in one notable state (New York), however, do not accord "merits" status to default judgments. There are a number of references to default judgments in the Convention that indicate intent to cover such judgments, and conversations with the U.S. State Department confirm that the drafters of the Convention intended that it would apply to default judgments. They explain that the reference to decisions "on the merits" was intended to distinguish between final judgments as opposed to interim judgments (*e.g.*, order providing "interim measures of protection," such as injunctions). The State Department is expected to request that the final Report of the Convention clarify this intention (so as to inform courts when they subsequently interpret the Convention).

Conclusion:
Industry and regulators need to understand that whether a default judgment is entered "on the merits" will require a case-by-case analysis which they will want to determine under the law of both the chosen court and the requested state.

3. Public Policy Exceptions:
The Convention provides that a judgment may be refused enforcement if enforcement would be manifestly incompatible with the public policy of the country in which enforcement is sought/the requested state. This raises two particular circumstances: (a) enforcement of default judgments issued pursuant to a failure to comply with pre-answer security statutes and (b) challenges to enforcement of punitive damages provisions in insurance policies or reinsurance agreements.

a) **Pre-answer Security/Default Judgments**
Analyses of case law and reports of counsel presented by certain US industry members suggest that default judgments issued pursuant to U.S. state insurance code pre-answer security requirements may be unenforceable under public policy exceptions to enforcement in some foreign jurisdictions. The Convention does not address pre-answer security, which likely is a form of "interim measures of protection" the Convention excepts from its application. A problem could occur, *e.g.*, when a non-US defendant reinsurer fails to post pre-answer security. Should a court then enter a default judgment in favor of the cedent or receiver because of the reinsurer's failure to post security, as state statutes allow, that judgment might be challenged in a foreign court for a variety of reasons.

Conclusion:
Cedents and regulators need to understand that – as at present without the Convention - they should not in all circumstances rely exclusively on pre-answer security statutes to protect their interests in the case of a default. They may wish to consider, *e.g.*, incorporating governing law provisions in their agreements that specifically refer to and adopt such statutes.

b) **Punitive and Non-Compensatory Damages**
Insurance policies and reinsurance agreements may provide for coverage of punitive/non-compensatory damages assessed against either the policyholder or the ceding insurer. It is against the public policy of some U.S. as well as non-US jurisdictions for one party to agree to indemnify, or obtain enforcement of judgments or awards of, punitive damages. Language adopted in the Convention specifically provides that judgments in respect of liabilities under the terms of insurance and reinsurance contracts that include liability to indemnify non-compensatory damages - that might otherwise be refused under the Convention - shall not be limited or refused.

Conclusion:
So long as the subject insurance policy or reinsurance agreement expressly and lawfully recognizes that punitive/non-compensatory damages are covered, adoption of the Hague Convention should resolve this issue. Accordingly, parties need to "draft into" the Convention by reference.

4. Insolvency
The Convention may not provide a means for state insurance receivers to enforce certain judgments under state receivership authority. The Convention relates to "private international law," not "public law" matters, and does not apply to "insolvency." At the same time, Article 2(5) states that proceedings are not excluded from the scope of the Convention "by the mere fact that a State, including a government, a governmental agency or any person acting for a State, is a party thereto." As the Special Commission noted in its *Draft Report,* "*[o]nly proceedings directly concerning insolvency are excluded* from the scope of the Convention." The Convention thus observes the analogous bankruptcy distinction between "core" and "ancillary" proceedings. Accordingly, a judgment improvidently entered by a court on a matter of statutory insolvency law (*e.g.*, a reinsurer's right to a certain set-off, the relative priority/class level or distribution for payment of a reinsurance-related obligation, or an attempt to estimate and accelerate reinsurance recoveries) may not be enforceable under the Convention. At the same time, a judgment of coverage entered under an insurance policy or reinsurance agreement - even though a party is insolvent - will fall within the scope of, and should be enforceable under, the Convention. The Convention's drafters note that government officials may utilize the Convention to the extent that they are a party (or stand in the shoes of a party) to a commercial contract, but they may not use it to exercise powers that a private person could not exercise.

Conclusion:
Regulators and receivers need to understand that should they attempt to use statutory or receivership court-granted authority that is not reflected in the terms agreed to in an insurance or reinsurance agreement, they may not be able to rely on the Convention to enforce a judgment on such a claim against a non-US insurer or reinsurer. The extent to which a governing law provision or a "standard" insolvency clause may affect the outcome in such a matter, however, should be considered. It is suggested that appropriate entries be made in the NAIC *Receivers Handbook* and that training in such matters be included for regulators and receivers.

5. Declarations with Respect to Specific Matters
Consistent with the sovereign power of U.S. states when adopting model or uniform laws or regulations, the Hague Convention allows jurisdictions to declare that certain matters are not subject to the Convention as ratified in that jurisdiction. For example, matters dealing with asbestos (Canada), natural resources (China), and joint ventures (China) were identified as likely exceptions for the particular countries identified parenthetically during the drafting of the Convention. The language of the Convention addressing insurance and reinsurance were not intended to overcome the declaration rights of ratifying countries. The declaration provisions in the Convention likely would empower a declaring

country's courts to refuse enforcement of insurance and reinsurance obligations related to such matters, unless the declaration did not extend to judgments entered under insurance or reinsurance contracts.

Conclusion:
Industry and regulators around the world should work to encourage countries to refrain from adopting declarations with respect to specific matters as they act to ratify the Hague Convention. For example, they could encourage countries to except from their declarations judgments arising out of or relating to insurance or reinsurance agreements covering such matters. The policy positions taken by international bodies such as the IAIS might provide significant support in this effort. It has also been suggested that (depending on applicable governing law) parties might be able to draft insurance and reinsurance contracts so as to waive the "protections" that declarations would otherwise provide.

NEXT STEPS

The Interested Persons group is happy to answer any questions from the Reinsurance Task Force and seeks input and guidance with respect to next steps and deadlines.

Respectfully submitted,

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Attachment A

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