

# US REINSURANCE REGULATION: A REINSURANCE MARKET PERSPECTIVE

By

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## ***I. INTRODUCTION***

The increasingly important role that reinsurance plays in the insurance marketplace cannot be over-emphasized. From 1997-1998, premiums for life reinsurance climbed 58 percent while the growth of life reinsurance companies has averaged 25 percent over the past three years. In 1998, approximately US \$44 billion in life reinsurance premium was assumed.<sup>2</sup> Statistics show that total ceded property/casualty premium from US cedents to non-US reinsurers climbed from nearly \$15 billion in 1996 to over \$25 billion in 2000. Likewise, total reinsurance recoverables on property/casualty losses due to US cedents from non-US reinsurers rose from over \$41 billion in 1996 to close to \$57.7 billion in 2000.<sup>3</sup> (See Table 1 and 2) The net reinsurance recoverables on all paid and unpaid property/casualty losses in 2000 represent 144.2 percent of the surplus of US property/casualty insurers.<sup>4</sup>

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The RAA is the United States' leading trade association representing US property/casualty (non-life) reinsurers. The RAA's members assume more than 75% of the reinsurance premium ceded by US insurers to US reinsurers. Approximately 40% of the RAA membership is foreign-owned.

<sup>2</sup> AMERICAN COUNCIL OF LIFE INSURERS, THE ANNUAL REPORT ON REINSURANCE PREMIUMS AND OPERATING ITEMS (1998). ACLI survey of North American companies representing 90 percent of the ordinary life reinsurance industry.

<sup>3</sup> REINSURANCE ASSOCIATION OF AMERICA, ALIEN REINSURANCE IN THE US MARKET 2000 DATA (2000) , at 3-4.

<sup>4</sup> BEST'S AGGREGATES & AVERAGES PROPERTY-CASUALTY UNITED STATES (A.M Best Co., ed. 2001); According to the NAIC Annual Statement Instructions for Property/Casualty insurers, property/casualty lines of business, include: fire, allied, farmowners multiple-peril, homeowners multiple-peril, commercial multiple-peril, mortgage guaranty, ocean marine, inland marine, financial guaranty, medical malpractice, earthquake, group accident and health, credit accident and health (group and individual), other accident and health, workers' compensation, other liability, product liability, auto liability, auto physical damage, aircraft, fidelity, surety, burglary and theft, boiler and machinery, credit, and international of the foregoing lines.

**Table 1**

<b>YEAR</b>	<b>TOTAL CEDED PREMIUMS IN \$MILLIONS</b>	<b>% Change</b>
2000	25,118	9.9%
1999	22,861	34.0%
1998	17,066	13.9%
1997	14,984	1.8%
1996	14,719	-

**Table 2**

<b>YEAR</b>	<b>TOTAL RECOVERABLES IN \$MILLIONS</b>	<b>% Change</b>
2000	57,703	9.1%
1999	52,873	14.9%
1998	46,024	9.4%
1997	42,060	1.4%
1996	41,471	-

Reinsurance is a key component of the insurance marketplace, reducing the volatility experienced by insurers and improving insurers' financial performance and security. The former Reinsurance Working Group of the International Association of Insurance Supervisors (IAIS) has recognized five primary functions of reinsurance: capacity, expertise, stability, financial and protection. The Working Group described these functions in the following manner:

*Capacity*

Reinsurance provides flexibility for insurers in the size and types of risk and the volume of business they can safely underwrite. It will allow the insurer to enter into new business, expand to or withdraw from a class or line of business and/or geographical area within a short period.

*Expertise*

Reinsurers supply assistance to insurers in specialized areas where the insurer may have little or no experience. The qualified members of staff of a professional reinsurer will offer services regarding the production process to new insurers in particular and/or to insurers taking up new business lines or expanding their area of operations to foreign countries.

### *Stability*

Properly structured reinsurance programs will assist insurers by limiting wide fluctuations in underwriting results. As a consequence, the limited risk spread will allow the insurer to reduce the required amount of security funds and/or its own funds, and hence the solvency margin. The aspect of security funds is directly related to the increasing importance of the shareholder value by the return on investment.

### *Financial*

Reinsurance assists in financing insurance operations as an alternative to increasing an insurer's capitalization. In this regard, the insurer may have the asset backing of many large reinsurers.

### *Protection*

Associated with stability, reinsurance provides for protection against the potential large accumulations that can result from catastrophic events; for example, earthquakes, bush-fires and cyclones.<sup>5</sup>

Reinsurance is a global business. Often, reinsurers reinsure risks from a number of insurers located in many jurisdictions, giving reinsurers a broad range of geographical exposures.<sup>6</sup> Because insurance supervisors tend to be aligned on the basis of nation states, the globalized nature of a reinsurer's business may make supervision on a local basis inherently difficult.<sup>7</sup>

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<sup>5</sup> IAIS WORKING GROUP ON REINSURANCE, REINSURANCE AND REINSURERS: RELEVANT ISSUES FOR ESTABLISHING GENERAL SUPERVISORY PRINCIPLES, STANDARDS AND PRACTICES 14, 15 (2000).

<sup>6</sup> See EU Study, *supra*, note 34, at 10.

<sup>7</sup> See EU Study, *supra*, note 34, at 10.

In 1999 primary insurers ceded business worth US \$125 billion to reinsurers worldwide (“Reinsurance,” August 2000). According to “Reinsurance” magazine (August 2000), 30 percent of the premiums written by the world’s top 100 reinsurance companies were written by the top five in 1999 and almost half (48%) were written by the top ten.<sup>8</sup> The top ten reinsurance groups, identified by market share (ranked by net written premiums) are as follows:

<b>Reinsurer</b>	<b>Primary jurisdiction</b>	<b>Total Net premiums written (US \$ million)</b>	<b>Combined rate (%)</b>
Munich Re	Germany	13,566	118.9
Swiss Re	Switzerland	12,839	116.0
Berkshire Hathaway	US	9,453	116.3
ERC	USA	6,921	114.0
Gerling Group	Germany	3,938	114.0
Lloyd’s	United Kingdom	3,799	N/A
ASS Generali	Italy	3,533	113.5
Allianze Re	Germany	3,299	107.4
SCOR Re	France	2,721	109.7
Source: Standard & Poor’s Global Reinsurance Highlights (2000 edition)			

<sup>8</sup> See EU Study, *supra* note, 34, at 28.

The global nature of the reinsurance market is illustrated by the number of reinsurers assuming risk from US cedents. In year 2000, more than 3,300 foreign reinsurers assumed business from US ceding insurers. Those reinsurers were domiciled in 100 foreign jurisdictions. In 2000, US reinsurers assumed approximately 53.4 percent of the premium ceded by US insurers while foreign reinsurers assumed approximately 46.6 percent of that premium.<sup>9</sup> (See Table 3)

**Table 3**

<b>YEAR</b>	<b>U.S. REINS. COMPANIES</b>	<b>ALIEN REINSURERS</b>
2000	53.4%	46.6%
1999	54.7%	45.3%
1998	57.7%	42.3%
1997	59.9%	40.1%
1996	61.2%	38.8%

The ten countries shown in Tables 4 and 5 represent approximately 92 percent of the unaffiliated premium reported in 2000. In most instances, sharp increases or decreases in premiums to a country are attributable to significant changes in writings of a few major companies.<sup>10</sup>

**Table 4**

<b>PREMIUMS CEDED TO UNAFFILIATED ALIEN REINSURERS</b>					
<b>(\$ IN MILLIONS)</b>					
<b>Domicile</b>	<b>1996</b>	<b>1997</b>	<b>1998</b>	<b>1999</b>	<b>2000</b>
Bermuda	3,884	4,192	3,806	4,440	5,354
United Kingdom	2,513	2,403	2,892	3,421	3,694
Germany	961	730	815	1,042	1,472
Barbados	122	154	230	728	1,126
Ireland	613	375	399	647	829
Cayman Islands	466	509	569	653	661
France	331	397	461	497	630
Switzerland	179	168	636	237	513
British Virgin Islands	356	377	395	411	451
Japan	358	291	271	298	375
<b>TOTAL</b>	<b>9,783</b>	<b>9,596</b>	<b>10,474</b>	<b>12,374</b>	<b>15,105</b>

<sup>9</sup> REINSURANCE ASSOCIATION OF AMERICA, ALIEN REINSURANCE IN THE US MARKET 2000 DATA (2000), at 14.

<sup>10</sup> *Id.*, at 7.

**Table 5**

<b>RECOVERABLES FROM UNAFFILIATED ALIEN REINSURERS</b>					
<b>(\$ IN MILLIONS)</b>					
<b>Domicile</b>	<b>1996</b>	<b>1997</b>	<b>1998</b>	<b>1999</b>	<b>2000</b>
Bermuda	7,440	7,288	7,230	8,261	9,892
United Kingdom	9,100	8,815	9,894	10,653	10,158
Germany	2,598	2,268	2,385	2,435	3,920
Barbados	3,181	3,030	3,066	3,102	4,299
Ireland	890	1,207	1,463	2,203	2,306
Cayman Islands	923	945	978	1,176	1,191
France	1,428	1,450	1,583	1,613	1,531
Switzerland	555	530	1,082	1,118	1,093
British Virgin Islands	478	570	640	692	731
Japan	994	924	944	901	895
<b>TOTAL</b>	<b>27,587</b>	<b>27,027</b>	<b>29,265</b>	<b>32,154</b>	<b>36,016</b>

The countries in Tables 6 and 7 represent approximately 96 percent of total premiums reported as ceded to affiliates. As in the case of unaffiliated reinsurers, sharp increases or decreases in premiums to a country are usually attributable to significant changes in writings of a few major companies.<sup>11</sup>

**Table 6**

<b>PREMIUMS CEDED TO AFFILIATED ALIEN REINSURERS</b>					
<b>(\$ IN MILLIONS)</b>					
<b>Domicile</b>	<b>1996</b>	<b>1997</b>	<b>1998</b>	<b>1999</b>	<b>2000</b>
Bermuda	1,783	1,799	2,629	4,670	5,271
Cayman Islands	73	256	583	951	884
Switzerland	660	609	728	466	670
Germany	264	326	355	421	484
United Kingdom	292	326	336	381	417
Turks & Caicos	211	76	100	631	300
Barbados	230	317	258	229	219
France	103	103	92	115	216
Luxembourg	22	9	16	14	57
Japan	48	40	27	443	51
<b>TOTAL</b>	<b>3,686</b>	<b>3,869</b>	<b>5,124</b>	<b>8,321</b>	<b>8,569</b>

<sup>11</sup> *Id.*, at 11.

**Table 7**

<b>RECOVERABLES FROM AFFILIATED ALIEN REINSURERS</b>					
<b>(\$ IN MILLIONS)</b>					
<b>Domicile</b>	<b>1996</b>	<b>1997</b>	<b>1998</b>	<b>1999</b>	<b>2000</b>
Bermuda	5,009	5,998	6,806	9,040	11,053
Cayman Islands	564	669	979	1,324	1,693
Switzerland	1,183	1,145	1,187	1,598	2,244
Germany	758	866	897	1,226	1,539
United Kingdom	521	488	715	689	695
Turks & Caicos	41	42	192	394	383
Barbados	1,281	1,184	1,384	938	571
France	190	187	178	237	224
Luxembourg	1	2	7	14	44
Japan	123	133	104	436	175
<b>TOTAL</b>	<b>9,671</b>	<b>10,714</b>	<b>12,449</b>	<b>15,896</b>	<b>18,621</b>

## **II. REGULATORY PHILOSOPHY**

The insurance and reinsurance industries are, for the most part, government-regulated throughout the world. The method and the extent of regulation reflects the philosophy of government and their perception of what is necessary to protect the best interests of their country, whether those interests are consumer or business-oriented. In many countries, the purpose of insurance regulation is to protect the insurance buyer, most of whom are unsophisticated in insurance matters, from abuses as well as from the risk that an insurance company may be unable to pay for losses due to insolvency.<sup>12</sup> Another purpose of regulation is to further the national interest to foster the domestic industry by protecting it from foreign competition.<sup>13</sup> This purpose is often misplaced for a number of reasons. First, most countries have a total insurance industry capacity grossly inadequate to cover large exposures such as natural catastrophes. Secondly, the capacity, risk management and other expertise that is available in the global marketplace can result in strengthening and growing the domestic market, providing jobs and the influx of needed capital.

The reinsurance regulatory philosophy adopted in the United States is focused on solvency and recognizes a difference between the needs of consumers and the customers of reinsurers. While regulation of primary<sup>14</sup> insurance focuses on the insurer's solvency, it also acts to protect the general public to prevent fraud, overcharging, misleading advertising, and other harmful

<sup>12</sup> ROBERT W. STRAIN, REINSURANCE CONTRACT WORDING, at 615 ¶ 2 (1992).

<sup>13</sup> *Id.*

<sup>14</sup> While the US tends to use the term "primary" insurer, other jurisdictions, like the European Union, often use the term "direct" insurer. Both terms are used interchangeably throughout this paper.

practices.<sup>15</sup> To this end, US regulators provide for the licensing and regulation of agents and brokers, the regulation of rates and forms, and for the establishment of certain standards to be met by each insurer in its operations.<sup>16</sup>

The US regulatory philosophy with respect to reinsurance focuses on the solvency of the company. Concern for the buyer is minimal because the parties to reinsurance contracts are recognized as sophisticated in insurance matters and capable of protecting their own interests. Consequently, US reinsurance regulation exempts from supervision the rates charged and the form of contract used.<sup>17</sup> While concern for the buyer is minimal from a market conduct perspective, the security of reinsurance arrangements of a primary insurer is clearly of vital importance for the protection of its policyholders.<sup>18</sup>

### **III. VARYING LEVELS OF REINSURANCE REGULATION THROUGHOUT THE WORLD**

It has long been recognized that the level of reinsurance regulation varies substantially in countries throughout the world. The United States, which imposes a very highly structured level of regulation upon licensed reinsurers stands in stark contrast to countries like Belgium and Ireland where reinsurers are subject to no direct reinsurance supervision and Greece where reinsurers are subject to no supervision whatsoever.<sup>19</sup>

While some countries impose what has been characterized as “equal or nearly equal treatment” of “professional” reinsurers<sup>20</sup> and direct insurers,<sup>21</sup> other countries employ a “reduced regime” of direct supervision,<sup>22</sup> and still others combine some elements of direct supervision with indirect supervision.<sup>23</sup>

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<sup>15</sup> Strain, *supra*, note 12.

<sup>16</sup> Strain, *supra*, note 12.

<sup>17</sup> An additional reason for exempting form regulation for reinsurance is the fact that reinsurance contracts are individually negotiated and drafted as opposed to standardized forms used by primary insurers.

<sup>18</sup> See EU Study, *supra*, note 34, at 3.

<sup>19</sup> GESAMTVERBAND DER DEUTSCHEN VERSICHERUNGSWIRTSCHAFT & BRITISH INSURERS’ INTERNATIONAL COMMITTEE, DRAFT FRAMEWORK FOR A EUROPEAN REGIME FOR THE SUPERVISION OF CROSS-BORDER REINSURANCE, at Enclosure A (1999) [hereinafter DRAFT FRAMEWORK FOR A EUROPEAN REGIME].

<sup>20</sup> The term “professional reinsurers” is used here only for clarity since the term has been used in the references cited. It is not typically used in the US.

<sup>21</sup> See DRAFT FRAMEWORK FOR A EUROPEAN REGIME, *supra*, note 19, Denmark, United Kingdom, Finland and Portugal.

<sup>22</sup> See DRAFT FRAMEWORK FOR A EUROPEAN REGIME, *supra*, note 19, Austria, Italy, Spain and Sweden.

<sup>23</sup> See DRAFT FRAMEWORK FOR A EUROPEAN REGIME, *supra*, note 19, Germany, France and the Netherlands.

This summary of the level of reinsurance regulation was derived from the results of a questionnaire submitted by the EU Commission to member countries and published in 1999.<sup>24</sup> As noted by other commentators, the results not only reflect the diversity of reinsurance regulation in the EU alone, but the fact that there is no globally recognized method of conducting reinsurance regulation.<sup>25</sup>

#### **IV. REINSURANCE REGULATION IN THE US**

##### **A. Historical Perspective**

While reinsurance regulation varies substantially throughout the world, reinsurance regulation also varied to a large extent among the individual states in the US as recently as the 1950s.<sup>26</sup> Minutes of NAIC meetings dating back to 1949 and 1950 reflect regulators' concern about abuses relating to reinsurance and the annual statement reductions that states permitted.<sup>27</sup> A questionnaire issued by the NAIC during this time period resulted in responses from 46 states and territories and revealed the following differences in regulatory approach to reinsurance:

- at least one state prohibited cessions to non-admitted reinsurers;
- approximately six states denied financial statement credit to a reinsurer not licensed in that state;
- approximately five states denied financial statement credit to a reinsurer not licensed in a state in the US;
- approximately four states permitted financial statement credit for reinsurance ceded to non-admitted reinsurers if funds were withheld;
- approximately 13 states permitted financial accounting statement credit regardless of the entity to which the cessions were made as long as the reinsurer was solvent;
- approximately ten states had no law regarding financial statement credit for ceded reinsurance; and
- approximately four other states had other unique provisions.

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<sup>24</sup>See DRAFT FRAMEWORK FOR A EUROPEAN REGIME, *supra*, note 19, at 2.

<sup>25</sup> DRAFT FRAMEWORK FOR A EUROPEAN REGIME, *supra*, note 19.

<sup>26</sup> Insurance and reinsurance regulation in the United States is carried out on a state-by-state basis, not on a federal level. The National Association of Insurance Commissioners (NAIC) attempts to provide some coordination and consistency among the states through model laws and regulations, uniform statutory accounting principles and coordinated company examinations and databases. The NAIC is an organization consisting of the insurance regulators of all US states, territories and the District of Columbia.

<sup>27</sup> Debra J. Hall, *Credit for Reinsurance: An On-Going Regulatory Debate*, in REINSURANCE: FUNDAMENTALS AND NEW CHALLENGES 127, at 128.

Despite the discovery of these differences, the states continued to implement an inconsistent approach to reinsurance regulation until years later. In 1982, the Illinois Department of Insurance submitted a report to the NAIC that suggested 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.<sup>28</sup> As a result of this work, the first model law addressing credit for reinsurance was adopted in June 1984.<sup>29</sup>

## **B. Status of Direct Regulation of US Licensed Reinsurers**

Reinsurers licensed in at least one US jurisdiction are subject to the full spectrum of laws and regulations to which a primary insurer is subject. The exceptions to this general rule are rates and forms. Because reinsurance is conducted between sophisticated parties of essentially equal bargaining power, regulators do not impose regulatory requirements relating to the rates that can be charged for reinsurance or the forms that can be used to evidence the contractual terms.

As a result, reinsurers are subjected to regulation that requires, among other matters, the following:

- Minimum Capital and Surplus Requirements
- Risk-Based Capital Requirements
- Investment Restrictions
- Disclosure of Material Transactions
- Licensing (fit and proper) Requirements
- Disclosures/Prohibitions on Certain Fronting Transactions
- Obligations/Prohibitions with Respect to Reinsurance Intermediaries
- Asset Valuation & Requirements
- Examinations of the Reinsurer
- Insurance Holding Company Requirements
- Fraud Prevention
- Annual Statement Mandated Disclosures, Accounting and Filings
- Credit for Reinsurance
- Unfair Trade Practices
- Annual Independent Auditor's Reports
- Actuarial-Certified Loss Reserve Opinions
- Restrictions on Assumption Reinsurance Transactions

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<sup>28</sup> *Id.*, at 128.

<sup>29</sup> *See id.*, at 129.

### **C. Status of Indirect Regulation**

Recognizing the fact that an insurance marketplace as large as that found in the US is in need of a substantial amount of reinsurance capacity, US regulators do not prohibit non-US reinsurers from assuming reinsurance business in the US, nor do they pretend that they have the regulatory capability or resources to assess the financial strength or claims paying ability of non-US reinsurers.

The US has developed a system whereby the reinsurance transaction is regulated through the credit for reinsurance mechanism.<sup>30</sup> The fundamental concept underlying the US regulatory view is that a reinsurer must either be licensed and subject to the full spectrum of reinsurance regulation or provide collateral to ensure the payment of the reinsurer's obligations to US ceding insurers.

In taking this approach, the US has created a very open but secure marketplace. According to 2000 statistical data prepared by the RAA for property/casualty reinsurance, reinsurance premium was ceded to, or reinsurance recoverables were due from more than 3,300 reinsurers in over 100 foreign jurisdictions.<sup>31</sup>

As the world's largest insurance marketplace, the US is dependent on non-US as well as US reinsurance capacity. At the same time, US regulators cannot be expected to know, or to learn, the intricacies of accounting systems and regulatory schemes used throughout the world, necessary to determine the financial strength of non-US reinsurers. Because the ceding insurer is allowed financial statement credit for cessions to such non-US reinsurers, it is imperative that US regulators have the confidence that the non-US reinsurer is able and willing to pay its obligations to US ceding insurers as they become due. This is accomplished through the collateralization of the reinsurer's obligations. Collateralization eliminates the regulator's need to assess the level of regulation in the non-US reinsurer's domiciliary jurisdiction or the financial strength of the particular reinsurer. Collateralization ensures that funds are available to satisfy the non-US reinsurer's obligations whether it is solvent or not.

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<sup>30</sup> Credit for reinsurance is the financial statement accounting effect given to a ceding insurer if cessions are ceded in accordance with prescribed criteria. If the criteria are met, the ceding insurer may record a reduction in insurance liabilities for the effect of the reinsurance transactions.

<sup>31</sup> REINSURANCE ASSOCIATION OF AMERICA, ALIEN REINSURANCE IN THE US MARKET 2000 DATA (2000).

Collateralization of a non-US reinsurer's obligations also serves to ensure that funds are available in the event that the ceding insurer becomes insolvent. A lesson learned by regulators as a result of the large number of US insurer insolvencies that occurred in the 1980s<sup>32</sup> is the fact that an open reinsurance market can translate into substantial cost and difficulties in obtaining reinsurance recoveries in the event of a receivership.<sup>33</sup> Cost and difficulties are mitigated, or even eliminated, if sufficient collateral is provided to satisfy the obligations of the non-US reinsurer.

#### **D. Options for Non-US Reinsurers**

US credit for reinsurance laws provide a number of options for non-US reinsurers that seek to assume reinsurance risk from US ceding insurers. A non-US reinsurer may:

1. Obtain a license to conduct insurance/reinsurance in the US by establishing a separate affiliate entity or by directly "entering" the US through a particular state and establishing a branch in the US;
2. Establish a multiple beneficiary trust which secures its obligations to all US cedents plus a surplus amount which is, for an individual assuming insurer, US \$20 million (for Lloyd's the joint and several surplus amount is US \$100 million); or
3. Provide individual collateral (through a trust, letter of credit or other acceptable security) to each of its ceding insurers without the necessity of a surplus amount in addition to its obligations.

The US does not create barriers to non-US entities to prevent the establishment of an affiliate or a branch or by preventing the non-US entity from conducting business entirely from its off-shore location.

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<sup>32</sup> According to A.M. Best, 372 property/casualty insolvencies occurred in the US from 1969 through 1990. Of those insolvencies, 49 occurred in 1985 alone. A.M. BEST COMPANY, BEST'S INSOLVENCY STUDY – PROPERTY/CASUALTY INSURERS 1969 – SURE (1991). A similar study focused on the 290 US life/health insurers that became insolvent or were found to be financially impaired during the period 1976 through 1991. A.M. BEST COMPANY, BEST'S INSOLVENCY STUDY – LIFE/HEALTH INSURERS 1976 – SURE (Aug. 1992).

<sup>33</sup> Transit Casualty Company was declared insolvent and placed in receivership on December 3, 1985, by order of the Missouri Circuit Court. The company's liabilities were estimated at approximately US \$4 billion making it one of the largest insurance insolvencies in the US history. As of 1995, the receiver had collected US \$640.9 million, mostly from reinsurance recoveries. In his 1995 report (10 years after the insurer was placed in receivership), the Transit receiver noted the significant task that faced the estate in the years ahead – the need to collect reinsurance recoveries from 350 remaining reinsurers (Transit originally had 900 reinsurers) located in the US and in over 30 foreign countries. TRANSIT CASUALTY COMPANY, INSOLVENCY AND LIQUIDATION REPORT 3 (March 1995).

## V. REINSURANCE REGULATION IN NON-US JURISDICTIONS

While it is often difficult to ascertain the differences between regulations in foreign jurisdictions, a recent study conducted by KPMG is helpful. The study, dated January 31, 2002, was commissioned by the European Commission with the purpose of reviewing “the methodologies for prudential supervision of reinsurance with a view to the possible establishment of an EU framework.”<sup>34</sup>

The EU Study recognizes that the major common objective for supervision of reinsurance, in those jurisdictions where it is supervised, is the need for protection of the interests of the policyholders – the intent being to minimize the instances of reinsurer insolvency.<sup>35</sup>

The EU Study notes that the IAIS has classified the varying types of supervision into five main categories, including:

- 1) no supervision at all;
- 2) supervision of reinsurance is restricted to ceded reinsurance of primary insurers only;
- 3) the supervisor is authorized to request non-public information about a domestic reinsurer;
- 4) every reinsurer doing business with a domestic insurer is licensed;
- 5) uniform licensing being extended with additional requirements for the insurer or the reinsurer.<sup>36</sup>

In describing the difference between direct and indirect supervision the study states

**Direct supervision** means that any reinsurer conducting business within a EU member state is required to be authorized in some way by the supervisor. Direct supervision includes other requirements, for example, managers must be fit and proper, adequacy of technical provision, minimum solvency margins, and submission of financial statements.

**Indirect supervision** is conducted via the full supervision of direct insurers. A reinsurer is examined as a result of the supervisor’s scrutiny of the primary insurer’s outward reinsurance program.<sup>37</sup>

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<sup>34</sup> The EU Study is available on the internet at [http://europa.eu.int/comm/internal\\_market/en/finances/insur/stud12-02-02.pdf](http://europa.eu.int/comm/internal_market/en/finances/insur/stud12-02-02.pdf).

<sup>35</sup> *Id.*, at 39.

<sup>36</sup> *Id.*, at 40.

<sup>37</sup> *Id.*, at 41.

## **A. European Union Member States**

The Study notes that almost all Member States of the EU supervise reinsurers either directly or indirectly or they have a mixture of both direct and indirect supervision.<sup>38</sup>

While primary insurance activities in the EU are regulated in accordance with EU directives, there is currently no “prudential directive” addressing reinsurance. There is, however, an effort underway to create such a directive.

According to the EU Study

Domestic professional reinsurers are not subject to any reinsurance supervision in Belgium, Ireland and Greece. Germany, France and the Netherlands apply elements of their direct insurance supervisory regime to reinsurers while a reduced licensing regime exists in Austria, Italy, Spain and Sweden where only the latter two impose solvency margin requirements.

Only in the UK, Denmark, Finland and Portugal are reinsurers subject to the comprehensive regulation and supervision applied to direct insurers under the single market regime, including licensing and thorough on-going financial supervision.<sup>39</sup>

The EU Study provides a chart at pages 43 and 44 concerning the elements of supervision imposed by individual countries and devotes pages 45 through 61 to a discussion of more detail concerning supervision in Denmark, Germany, Ireland, Italy, The Netherlands, Spain, Sweden, France, the UK, and the Lloyd’s market.

## **B. Canada**

The EU Study notes that reinsurance is explicitly defined and included within the overall regulation of the insurance business in Canada. Reinsurance may be bought from either licensed or unlicensed reinsurers. However, an unlicensed reinsurer must typically provide a letter of credit if the ceding insurer seeks to obtain reinsurance credit on its own statutory financial statements.<sup>40</sup>

Canadian regulators operate a licensing system and supervise the reinsurance business essentially the same way as they do direct insurance except that reinsurers are not subject to market conduct regulation. Like the US, minimum initial capital requirements for licensing in Canada are higher

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<sup>38</sup> *Id.*, at 41-42.

<sup>39</sup> *Id.*, at 42.

<sup>40</sup> *Id.*, at 61.

for reinsurers than for direct insurers, reflecting the perceived greater inherent risks in reinsurance.<sup>41</sup>

### **C. Bermuda**

The EU Study reports that the approach to the regulation of reinsurance broadly follows that of direct insurance and that there is no difference in the methodology for calculating solvency margins.<sup>42</sup>

It is interesting to note that a license is required in order to assume reinsurance business in Bermuda.<sup>43</sup>

### **D Switzerland**

According to the EU Study, while reinsurance is covered in insurance regulation, most requirements for direct insurance companies do not apply to reinsurance companies. Thus, foreign reinsurers, who assume business in Switzerland, require no authorization to do so and are exempted from federal supervision. However, authorization and supervision are required for Swiss reinsurers. Further, there is no requirement in Switzerland that companies provide the regulator with details of collateral or deposits. There are reportedly no current plans in Switzerland to review the treatment of ceded reinsurance.<sup>44</sup>

## ***VI. DIFFERENT RATIONALE FOR DIRECT AND INDIRECT SUPERVISION***

In designing a system of reinsurance regulation, it is essential that regulatory authorities consider the rationale upon which their system should be based. Obtaining knowledge about how reinsurance regulation is implemented in other jurisdictions is instructive but confusing when there exists the significant variation that we see throughout the world today.

The fundamental question is whether one believes that reinsurance should be regulated. Assuming that one believes that it should, the next question is whether there should be established a system of direct regulation, indirect regulation, or both. Of course, the detail of the components of direct and indirect regulation is the most complex part of the equation.

But let's examine the philosophy behind direct and indirect regulation because recent evidence suggests that it might not be consistent among regulatory authorities. Indeed, if KPMG has accurately assessed the rationale for the distinction in the EU, this author suggests that the rationale is significantly different in the US.

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<sup>41</sup> *Id.*, at 62.

<sup>42</sup> *Id.*, at 67.

<sup>43</sup> *Id.*, at 67.

<sup>44</sup> *Id.*, at 68-69.

The EU Study states

[t]here are two levels at which supervision can be applied to reinsurance business: direct supervision and indirect supervision. Indirect supervision, which focuses on the reinsurance arrangements of the direct insurer, is aimed at protecting policyholders against the risk of a direct insurer defaulting as a result of a failure in its reinsurance protection. The primary purpose of direct supervision of reinsurance companies is to maintain confidence in a country's reinsurance market. The fact that those jurisdictions which do regulate reinsurers do not prohibit direct insurers from placing cover with unregulated reinsurers indicates that they do not consider direct supervision of reinsurance to be a pre-requisite for the protection of policyholders, although clearly any rules which serve to promote the secure operation of reinsurers should, in turn, enhance the security of direct insurers and thereby indirectly improve the protection of individual policyholders.

Direct and indirect supervision, therefore, have distinct purposes. It follows that it is possible for a jurisdiction to have either or both direct and indirect supervision. Direct and indirect supervision are not alternatives to each other.<sup>45</sup>

While the KPMG analysis quoted above may be accurate with respect to the regulatory philosophy of some EU jurisdictions, it is fundamentally inconsistent with the rationale behind US reinsurance regulation and its use of both direct and indirect forms of reinsurance regulation.

The authors of the study suggest that EU countries, if they regulate reinsurers at all, do so for authorized reinsurers while non-domestics can assume reinsurance risk on a cross border basis without regulatory consequences or collateral requirements. This is not true in the US

A reinsurer that is not licensed in the US must provide collateral to the extent of its liabilities plus a solvency margin or provide collateral in the amount of the credit that the cedent takes on its statutory financial statements. Therefore, in the US, the purpose of direct and indirect regulation is the same – to ensure the solvency of the reinsurer and to ensure that funds are available to the US ceding insurer in the event of the reinsurer's insolvency, either through regulatory jurisdiction over the licensed reinsurer or through access to funds of the unlicensed reinsurer that are located and secured in the US.

## ***VII. EFFORTS TOWARD MUTUAL RECOGNITION***

There has been an effort during the past several years to create a system of mutual recognition among countries. This effort, led by European trade associations, seeks to establish a system where a country recognizes the reinsurance regulatory system of other countries and allows reinsurers to conduct business without the additional imposition of regulatory requirements. If such a system were established, European reinsurers would be permitted to assume reinsurance risk in the US without having to obtain a US license and without having to provide collateral for their liabilities to US ceding insurers. This would be the result even if the European reinsurer

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<sup>45</sup> *Id.*, at 74.

was domiciled in a country with far less reinsurance regulation than that which is imposed by US regulators on US licensed reinsurers.

The RAA has challenged this effort for several reasons. Although US reinsurers recognize the value of a more efficient reinsurance regulatory system, mutual recognition cannot be accomplished on a worldwide basis, or even a regional basis, until certain other events occur.

First, there needs to be created and implemented, an international accounting system, which provides more transparency between different existing systems. That effort, though underway, is years from becoming a reality.

Second, there must first be mutual recognition among the states within the US. It makes no sense whatsoever for regulators to place trust and confidence in the regulatory systems of foreign jurisdictions before and until they afford that trust and confidence to their counterparts in the US.

And finally, any level of foreign regulation, which is mutually recognized by the US, must become the new cap for the level of regulation imposed by US regulators on US licensed reinsurers. There is no legitimate rationale for imposing a higher level of regulation on US reinsurers than that which US regulators are prepared to accept from those who are regulated abroad.

There are differences in the insurance markets throughout the world. In some countries, there are only a few companies that assume reinsurance risk while US ceding insurers cede to over 3,300 reinsurers located in more than 100 foreign jurisdictions. While the RAA does not seek to export the US reinsurance system to those countries where few reinsurers assume risk, it does advocate the need for substantially the same level of regulation to be imposed if those reinsurers want to assume business from the US on a mutual recognition basis.

As regulators examine other regulatory systems and consider the development of regulatory approaches in their own countries, it is important to be aware of this current European effort and the effect that it may have on any system they choose to adopt.

## ***VII. US REINSURANCE INDUSTRY VIEWS OF REINSURANCE REGULATION***

The United States' regulatory system is not ideal, nor is the regulatory regime in any other jurisdiction likely to be. US reinsurers do not seek to export the US system of reinsurance regulation to other countries. At the same time, US reinsurers are vigilant about maintaining a level playing field among all competitors and striking the proper balance between a global, efficient marketplace and one that is financially secure for ceding insurers and consumers.

The RAA has long been an advocate for strong reinsurance regulation. US reinsurers have seen the problems of past insolvencies when weak players entered and exited the marketplace, leaving the stronger reinsurers with harsher regulation imposed on them in an attempt by regulators to avoid a repetition of the same problems. That stronger regulation is accompanied by a higher cost of doing business which is borne not by the weak players that exited the market but by the

long-term players that were not the cause of the problem in the first instance. Strong reinsurance regulation is at best a deterrent to the entry of such marginal reinsurers in the marketplace and, at worst, a means of detecting the weak players at an earlier stage.

Ceding company clients suffer from the absence of strong reinsurance regulation. Insolvencies in the US are administered by the insurance departments and, to a large extent, policyholders and claimants are paid by guaranty associations. Guaranty associations are funded by the solvent insurance industry. To the extent that reinsurance recoveries are unavailable due to the reinsurer's insolvency, or laws that prevent or restrict the collection of such recoveries, guaranty associations are not repaid for the funding they provide to policyholders and claimants. The primary insurance industry bears that loss and the cost of business is increased, resulting in higher costs to the consumer.

Therefore, strong reinsurance regulation is in the best interests of regulators, licensed reinsurers, primary insurers and the insurance-buying public.

## ***IX. CONCLUSION***

The world is changing--at a fast pace. The way in which reinsurers do business is changing, the products and services they offer is evolving, the range and characteristics of their competitors and their clients is expanding. Reinsurers have been in the forefront in anticipating these changes and in advocating greater regulatory efficiencies to expand their opportunities in a global marketplace.

Technology, global events, convergence of financial markets combine to offer regulators the opportunity to effect fundamental change to the insurance and reinsurance regulatory regimes that have existed in the past. However, this opportunity carries with it the burden of ensuring that the critical balance between efficiency and financial security is reached.

The United States has a very open reinsurance marketplace, as illustrated by the substantial participation of non-US reinsurers. At the same time it is a highly regulated environment that places solvency first and foremost, including the collectability of reinsurance recoverables.

Both the components of direct and indirect regulation imposed by the US system are focused on ensuring the solvency of the reinsurer and ensuring that in the event of the reinsurer's insolvency, the funds that become due to ceding insurers will be available in the US to pay those obligations.

There is a clear and concise regulatory philosophy in the US and the system that regulators have designed over the years is consistent and effective in implementing that philosophy. For those jurisdictions that are designing and implementing systems for the regulation of reinsurance, it is crucial that they identify their goals and adopt a philosophy consistent with those goals and with the nature of the marketplace they are charged with regulating.