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Feature Articles

IRU, Inc.
Intermediaries & Reinsurance Underwriters Association

Intermediaries & Reinsurance Underwriters Association

Mission Statement

To promote professionalism and educational advancement, and to provide a forum for the useful exchange of ideas among member companies.

Purposes

The purposes for which IRU, Inc. (Intermediaries & Reinsurance Underwriters Association) was formed are to foster and promote the interests of those individuals, partnerships, firms, associations and corporations who are engaged in the business of treaty reinsurance.

- To encourage an exchange of ideas among members, and to disseminate educational information for the benefit of members and for the betterment of the reinsurance industry.
- To promote professionalism among members.
- To maintain liaison with other segments of the insurance industry, for the discussion and debate of insurance and reinsurance issues.
- To develop and present programs on topics germane to the fields of insurance and reinsurance.
- To organize and conduct meetings for the members of the association.
- To facilitate research into problems and issues significant to either the membership or the reinsurance industry.
- To disseminate, through printed matter and other appropriate means, general news and information concerning the association and its members, the proceedings of the associations meetings and programs.
- To promote programs designed to increase awareness and enhance positive image of the reinsurance industry.

General Information

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Wall Street Reform and Consumer Protection Act: Its Impact on Reinsurers

By

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Prior to forming her arbitration and regulatory consulting practices in late 2008, Ms. Hall was the former Senior Vice President and General Counsel of the Reinsurance Association of America (RAA); a former Senior Vice President and the Senior Regulatory Counsel for Swiss Re America; General Counsel of the Illinois Office of the Special Deputy Receiver and a government litigator and Special Assistant Attorney General as well as Deputy General Counsel for a major state agency. She has been active in reinsurance regulatory reform since 1990.

Ms. Hall has testified on regulatory reform before the U.S. Congress and has worked closely with legislative staff in contributing to several of the regulatory reform bills mentioned in this article, including the language that ultimately was incorporated into the Dodd-Frank legislation (which as this article points out, was incorporated from previous legislation dating back to 2006 and 2008). Ms. Hall was, for several years, the Chair of the NAIC Interested Persons group which took a leadership role in NAIC collateral reform efforts and which originally proposed a regulatory framework that formed the foundation for the NAIC's regulatory reform proposal. Ms. Hall was Swiss Re group's primary

representative to the International Association of Insurance Supervisors (IAIS) and, as such, was significantly involved in the development of the IAIS Guidance Paper on the Mutual Recognition of Reinsurance Supervision.

Abstract: This article provides a brief overview of U.S. reinsurance regulation reform efforts during the past two decades. The author discusses the concept of regulatory (mutual) recognition in the international context, as it relates to reinsurance regulation. She includes a discussion of recent NAIC attempts to reform collateral laws and regulations and how those efforts impact on regulatory recognition. The author discusses the impact of the Dodd-Frank Wall Street Reform and Consumer Protection Act as it relates to reinsurers, generally, and international regulatory recognition, specifically.

Introduction

Reinsurers' views toward regulation have evolved dramatically during the past two decades. While regulators and policymakers have been slow to react, the new reform legislation, as a direct result of the financial crisis, has provided at least the first steps toward a more modernized reinsurance regulatory framework. But we aren't there yet.

Background -- Evolution of Regulatory Focus on Reinsurance

Until the 1980s, there was little concerted focus on reinsurance from state regulators. Reinsurers were regulated for solvency but any other form of direct regulation was lacking, in large part. However, indirect regulation was developing through various state credit for reinsurance laws, which determined the circumstances under which a ceding insurer could take financial statement credit for its ceded reinsurance. In 1984, the National Association of Insurance Commissioners (hereinafter "NAIC"), promulgated a Model Law on Credit for Reinsurance.[1] That model, and amendments thereto, have been adopted, in one form or another, in every state. In 1991, the NAIC adopted a Model Credit for Reinsurance Regulation that expands on the model law. Both models are hereinafter collectively referred to as the "NAIC Models." The purpose of these models is to allow financial statement credit only when it is reasonably likely that the ceding insurer will be able to collect its reinsurance recoverables.[2]

The NAIC Models provided period grist for debate at the NAIC from their initial adoption through the mid-1990s, including: attempts by Lloyd's to ease the amount of funding in the Lloyd's trusts;[3] domestic reinsurers' concerns over the "quantity discount" once provided to the Institute of London Underwriters (ILU);[4] and the policy of a number of states to apply their credit for reinsurance laws on an "extraterritorial" basis, as opposed to limiting the applicability of their laws to their domestic insurers.[5] At the same time, Lloyd's was facing severe financial difficulties that ultimately resulted in the establishment of Equitas to handle the runoff of old years.[6] The result was an extended focus by regulators on reinsurer solvency and tightening of the NAIC Models.[7]

The adoption of the initial version of the NAIC Model Law on Credit for Reinsurance in 1984 coincided with the beginning of a spike in insolvencies of U.S. property and casualty insurers. Reinsurance recoverables are often the largest asset of an insurer's estate and some of the companies that became insolvent (*e.g.* Transit Casualty Insurance Company), were highly dependent on reinsurance. As the receivers of these insolvent insurers sought to marshal assets, disputes arose around various issues, particularly the issue of setoff, e.g., reinsurers setting off premiums due from cedents against losses due from reinsurers.[8] This led to extended debate at the AIC among receivers, regulators and the industry concerning the role of reinsurers in the insolvency process.

Perhaps the nadir of the reinsurance regulatory debate was reached upon the publication in February 1990, of a report entitled *Failed Promises: Insurance Company Insolvencies*, which was issued by the Subcommittee on Oversight and Investigations of the Committee on Energy and Commerce of the U.S. House of Representatives.[9] This report focused on the insolvencies of four large property and casualty insurers in the mid-1980s and "reserved some of its most severe criticism for the state system of regulating foreign (non-US) reinsurers, calling it the 'black hole' of solvency regulation."[10] For several years thereafter, there were (unsuccessful) efforts to pass federal legislation related to regulation of reinsurance.[11]

The upshot of these developments was to convert reinsurance from a regulatory backwater in 1980 to a major solvency issue in 1990. Previously believing that the less regulators knew about reinsurance - the better, reinsurers came to understand that a lack of understanding can lead to poor decision-making. Reinsurance companies, and their representatives, recognized this evolution and became much more active than in years past in participating in the regulatory debate at both the state and federal levels.

The Federal Road to Reinsurance Reform

Following the high level of activity of the 1990s, little happened in terms of regulatory reform for several years. In the early and mid 2000s, the country was focused on the horrific terrorist attack of September 11th and insurers and reinsurers turned their focus to legislation that would create a federal backstop in the event of another large-scale terrorist attack. Hurricane Katrina and other natural disasters, and the perceived increasing frequency of them, diverted the attention of the industry and policymakers from regulatory reform.

During the past several years, there has been renewed interest in the U.S. Congress, resulting in a variety of proposals aimed at insurance regulatory modernization.

Optional Federal Charter[12]

On April 5, 2006, Senate Banking Committee members John Sununu (R-NH) and Tim Johnson (D-SD), introduced the National Insurance Act of 2006, S. 2509. This legislation would have created a federal charter for both life and property/casualty lines of insurance and provided for the licensing and regulation of insurance producers and insurance agencies. Among other things, the bill would have created a new federal insurance regulator within the Department of

Treasury alongside the Comptroller of the Currency and the Office of Thrift Supervision. If a company opted for a federal charter, state insurance departments would have had little to no role in the regulation of the company. Reinsurers would have had the option to choose to be federally chartered.

Nonadmitted and Reinsurance Reform Act [13]

On September 27, 2006, the House approved by a unanimous vote, H.R. 5637 which would have streamlined state regulation in both the surplus lines and reinsurance arenas. The Nonadmitted and Reinsurance Reform Act of 2006 would have had the following effects on the reinsurance market:

- Given the ceding insurer's state of domicile sole authority to govern reinsurance contracts and determine whether or not a particular reinsurance contract qualifies for credit for reinsurance purposes;
- Prohibited states from applying their laws in an extraterritorial manner; and
- Provided uniform regulation of reinsurer solvency based upon the NAIC's accreditation standards.

Treasury Blueprint and OII [14]

Although the House Financial Services and the Senate Banking Committees' agendas were consumed in 2008 with the looming housing and credit crisis, Treasury Secretary

Paulson's release of the Treasury Department's Blueprint for Financial Regulatory Reform in late March spurred activity in the reinsurance regulatory world and quite a commotion as it was introduced during the NAIC quarterly meetings.

Building on Treasury's concept, on April 17, 2008, Chairman Kanjorski introduced H.R. 5840, the Insurance Information Act of 2008, which would have -

- Authorized the Treasury Secretary to advise the President and Congress on domestic and international insurance policy issues regarding all lines except health insurance;

- Created an Office of Insurance Information (OII) within the Department of Treasury;

- Authorized the OII to establish federal policy on international insurance matters; and

- Ensured that state laws were consistent with international trade agreements through limited preemptive powers, giving states the right to appeal to the Secretary any OII determination of inconsistency.

Reinsurance International Solvency Standards Evaluation Board

H.R. 5840 was followed by the introduction of H.R. 6213, the Reinsurance International Solvency Standards Evaluation Board Act of 2008, referred to the House Committee on

Financial Services. H.R. 6213, designed as either a stand-alone bill or a companion to other legislation, would have created a non-profit Board, appointed by the President, charged with certifying regulatory jurisdictions (U.S. or foreign) as having adequate reinsurance capital and risk management standards and an acceptable level of prudential supervision. Reinsurers supervised by certified jurisdictions would be treated in the same manner (credit for reinsurance standards) as reinsurers domiciled in their ceding insurer's domiciliary jurisdictions.

Expansion of Risk Retention Groups

On April 15, 2008, H.R. 5792 was introduced. The legislation would have expanded the Liability Risk Retention Act allowing risk retention groups (RRGs) the ability to offer commercial property insurance to their clients. The bill also would have improved regulation and corporate governance standards for RRGs.

Dodd-Frank Wall Street Reform

The Dodd-Frank Wall Street Reform and Consumer Protection Act (the Act or Dodd-Frank), was introduced on December 2, 2009, passed the House on December 11, 2009, passed the Senate on May 20, 2010, and was signed by the President on July 21, 2010. The effect of this legislation on reinsurers will be discussed below, but suffice it to say that the road to reform outlined above has culminated in legislation that began in the 109th Congress and had its roots in debates at the NAIC since the 1990s. The new law embodies the concepts introduced in H.R. 5840 in 2008 as well as the provisions contained in the Nonadmitted and Reinsurance Reform Act, dating back to its first introduction in 2006.

The NAIC Joins The Reform Efforts

Responding to increasing international pressure, the NAIC accelerated its efforts to create a single regulatory framework for reinsurers and a new reduced collateral regime. In 2008, the NAIC adopted a Reinsurance Regulatory Modernization Framework (NAIC Framework) and, in 2009, companion legislation that would implement the NAIC Framework. Together with the NAIC Framework, the legislation, called the Reinsurance Regulatory Modernization Act of 2009, would have:

- Established a Reinsurance Supervision Review Board (RSRB) as an instrumentality or agency of the United States;

- Created two types of reinsurers, National Reinsurers and Port of Entry (POE) Reinsurers;

- Authorized the RSRB to (1) evaluate state supervisory systems to determine whether they qualified as Home State Supervisors or POE Supervisors, (2) evaluate the supervisory systems of non-U.S. jurisdictions to determine if they were eligible for recognition by the RSRB, (3) develop sample supervisory recognition agreements and

> information sharing cooperation agreements to be entered into by POE supervisors and non-U.S. jurisdictions, and (4) enter into agreements with respect to confidentiality of information.

This proposal followed several years of discussion and debate at the NAIC, primarily at the Reinsurance Task Force level. The NAIC Industry Interested Persons had submitted in June 2006 a detailed report setting forth goals for modernization, potential regulatory frameworks at both the state and federal level and pros and cons of each. Similar to one of the proposals suggested by the industry, the NAIC Framework sought to establish home and host state regulators and reduced collateral for reinsurers domiciled in states and non-U.S. jurisdictions that met standards of regulatory supervision as well as individual financial strength qualifications. While the industry proposed that state and non-U.S. regulatory certification be carried out by the federal government, as well as certain other fundamental duties, the NAIC proposed from the beginning to accomplish these tasks through an NAIC Reinsurance Supervision Department (RSRD) as opposed to a federal commission.

Regulatory Recognition As A Defining Factor

Constitutional Obstacles to Mutual Recognition

Some in the industry challenged the NAIC's authority to engage in mutual recognition activities with foreign government entities. The constitutional bases for the industry's opposition included the Trade Agreements Act of 1979,[15] the

Foreign Affairs Doctrine,[16] the Foreign Commerce Clause,[17] and the Compact Clause.[18] Swiss Re commissioned a legal opinion from DLA Piper that explored the constitutional parameters and set forth, in detail, why the NAIC had insufficient authority to accomplish these tasks in the manner proposed.

Swiss Re's work at the IAIS, as discussed below, was focused on ensuring that the IAIS took into consideration not just "mutual" recognition but also "unilateral" recognition. While supporting bilateral and multilateral recognition, Swiss Re and others wanted to ensure that the U.S. could, indeed, be considered equivalent to jurisdictions such as Switzerland and the European Union, even if federal regulation was elusive and mutual recognition was never made constitutionally permissible.

As noted above, the NAIC itself developed the Reinsurance Regulatory Modernization Act of 2009, in an attempt to overcome these constitutional, as well as practical, hurdles.

IAIS Regulatory Recognition Efforts

Issues concerning mutual recognition were also being addressed at the International Association of Insurance Supervisors (IAIS). In October 2008, the IAIS adopted a Guidance Paper on the Mutual Recognition of Reinsurance Supervision (IAIS Paper). The IAIS paper states in part:

> The purpose of mutual or other forms of supervisory recognition is to facilitate the international supply of reinsurance (whether cross-border, through branches or via subsidiaries) by fostering the development of a framework for efficient and effective international supervision. For a number of years, the IAIS has used the term "mutual recognition" to refer to this process, but the objective can be achieved through unilateral, bilateral and multilateral approaches to recognition."[19]

The IAIS Paper goes on to explain that unilateral recognition refers to situations where a supervisor recognizes the supervision of another supervisor, without requiring that the latter recognize the supervision of the former. Bilateral refers to situations where the two supervisors recognize the supervision of one another and multilateral describes a situation where several supervisors recognize the supervision of each other.[20]

The Need for Regulatory Recognition

Regulatory recognition is a key aspect of a modernized regulatory framework. In some cases there is a mismatch between supervisory systems and the economic reality of the business. For example, supervision tends to be legal entity focused and carried out in the jurisdiction of domicile (except in the U.S. where regulatory requirements are imposed in some states on the basis of licensure). Although there is value to this form of regulation, it is inconsistent with the global nature of many groups. It does not necessarily take into account the internal retrocessions of a group, parental guarantees, or the concept of risk diversification. Reinsurers' business models are generally based on the widest possible distribution of risks, both in terms of geography and business lines. Thus, encouraging groups to operate across jurisdictional lines is consistent with the economic reality of how reinsurance groups operate and generally consistent with the underlying principles of risk diversification and distribution. Requiring different, overlapping, or sometimes inconsistent or conflicting regulatory structures is counter productive to competitive and commercial interests and ultimately operates against regulatory interests as groups attempt to straddle these lines in inefficient and unproductive ways.

At the heart of regulatory recognition is the ability of reinsurers to assume business in another jurisdiction without being subject to the recognizing jurisdiction's regulation and without being required to comply with additional regulatory requirements. Some would say that once a regulatory regime is recognized, there should be no additional burdens, e.g., no collateral, imposed on the reinsurer. Others would argue that the recognizing jurisdiction has the right to determine to what extent, and under what conditions, reinsurers from the recognized jurisdiction can do business.

These are fundamental policy determinations that the United States must make if reinsurance regulatory modernization is to become a reality. It is essential that they be made in a clear and uniform manner, and it is, in the author's view, the province of the federal government to make them.

Dodd-Frank Wall Street Reform and Consumer Protection Act - Its Impact on Reinsurers and Reinsurance Transactions

Americans have faced the worst financial crisis since the Great Depression. With the loss of millions of jobs, failed businesses, reduced housing prices and wiped out savings - Congress acted to restore responsibility and accountability to the financial system, as a whole, in an effort to restore confidence of the American people.

Financial Services Oversight Council

Among the many sweeping changes passed in the Dodd-Frank Wall Street Reform and Consumer Protection Act, was the establishment of the Financial Services Oversight Council (FSOC), in Title I, Subtitle A, of the Act, to identify and monitor systemic risks posed by financial firms and financial activities and practices. Chaired by the Treasury Secretary, the FSOC comprises ten voting members, who are the heads of the Federal financial regulatory agencies, the new Bureau of Consumer Financial Protection and an independent member with insurance expertise; and five nonvoting members, who are the heads of the new Office of Financial Research and the new Federal Insurance Office, a State commissioner, a State banking supervisor and a State securities commissioner.

The FSOC is charged with designating U.S. and non-U.S. non-bank financial companies that could pose a threat to the financial stability of the United States. Designated companies are required to register with the Federal Reserve, and, along with bank holding companies with consolidated assets of $50 billion or more, are subject to supervision and enhanced prudential standards established by the Federal Reserve Board.

Particularly significant to the (re)insurance industry is the ability of the FSOC to determine (pursuant to multiple criteria) whether U.S. and non-U.S. nonbank financial companies (including (re)insurers) pose a risk to the financial stability of the U.S. if they were to fail. If determined to be systemically important, the Federal Reserve has the authority to supervise the entity. There is no minimum asset threshold for non-bank financial companies subject to this determination.

The FSOC can make recommendations to the Federal Reserve Board for stricter prudential standards to be applied to designated companies and bank holding companies. It may also make recommendations to the primary financial regulatory agencies to apply new or heightened standards and safeguards for financial activities or practices. Primary financial agencies must adopt or explain their determination not to adopt the recommendations within a 90-day timeframe.

Importantly, the FSOC duties include identification of gaps in regulation; monitoring and advising Congress on domestic and international financial regulatory proposals and developments, including insurance and accounting; to discourage excessive growth/complexity; and to make recommendations aimed at enhancing U.S. competiveness and efficiency.

Title I, Subtitle C, of the Act authorizes the Federal Reserve to establish prudential standards for designated companies and bank holding companies which are more stringent than those applicable to like companies not presenting similar risks to U.S. financial stability. The Office of Thrift Supervision is abolished, and the FDIC and OCC are given enhanced authority. This new regime for monitoring and limiting systemic risk is supported by a new Office of Financial Research within Treasury to support the FSOC, collect financial data, develop tools for risk monitoring and prepare public reports to Congress.

Federal Insurance Office Act of 2010

Title V, Subtitle A, of the Act establishes the Federal Insurance Office (FIO), authorized to

- Monitor the (re)insurance industry, including identifying issues or gaps in the regulation of (re)insurers that could contribute to a systemic crisis in the industry or the U.S. financial system;

- Recommend to the FSOC insurers as systemically important and that should be subject to regulation as a nonbank financial company supervised by the Federal Reserve;

- Assist the Treasury Secretary in administering the Terrorism Risk Insurance Act (TRIA) program;

- Coordinate/develop federal policy on prudential aspects of international matters, including representing the U.S. before the IAIS;

- Assist the Treasury Secretary in negotiating international agreements ("covered agreements");

- Pre-empt state measures subject to covered agreements and which discriminate against non-U.S. insurers;

- Consult with state regulators on insurance matters of national importance and prudential matters of international importance; and

- Serve in an advisory capacity on the Financial Stability Oversight Council.

Covered Agreements

As noted above, the FIO is authorized to assist the Treasury Secretary in negotiating covered agreements.[21] "Covered agreements" are defined as "written bilateral or multilateral agreements regarding prudential measures with respect to the business of insurance or reinsurance" that are entered into between the U.S. and a foreign government or regulatory entity. Aside from describing what is, in essence, mutual recognition agreements as discussed above, the Act defines a covered agreement as one which

> *relates to the recognition of prudential measures with respect to the business of insurance or reinsurance that achieves a level of protection for insurance or reinsurance consumers that is substantially equivalent to the level of protection achieved under State insurance or reinsurance regulation.*

Thus, the authority to enter into mutual recognition agreements carries with it cumbersome notification and justification requirements[22] and introduces to the reinsurance industry the concept of consumer protection. Requiring that the level of protection be "substantially equivalent" is a higher standard than desirable though the term is defined as requiring only a "similar outcome." It is unclear how this standard will be applied to reinsurance, considering that reinsurance is not a right to which consumers are entitled to expect protection. The basis and standards for measurement could be difficult and fraught with potential mischief, potentially opening the door to consumer rights vis-à-vis reinsurers that never previously existed.

Preemption Process

Once a bilateral or multilateral agreement is entered into, the FOI is authorized to determine whether State insurance measures are preempted by the covered agreements. The standard for preemption is whether the State measure

> (1) results in less favorable treatment of a non-United States insurer domiciled in a foreign jurisdiction that is subject to a covered agreement than a United States

insurer domiciled, licensed, or otherwise admitted in that State; and

(2) is inconsistent with a covered agreement.

Before the FOI makes a determination that the above-referenced standard is met, it must notify the State, notify and consult with the USTR, publish notice in the Federal Register and provide interested parties a reasonable opportunity to submit written comments. Upon making the determination, the FOI is required to give further notice to the State and various Congressional committees. Additionally, determinations made by the FOI are subject to the Administrative Procedures Act, except that any court review shall be de novo.

Clearly, this process is overly cumbersome and the result of political compromise,[23] not an attempt to define an efficient and rational process to modernize reinsurance regulation. The need for reinsurance regulatory modernization is significantly overdue. The challenges of identifying, analyzing, comparing and making determinations about key components of foreign regulatory systems cannot be overemphasized. But burdening the process with the logistical obstacles embodied in the Act unnecessarily compounds these inherent problems, and may well make a difficult process insurmountable.

Added to these substantive and procedural burdens is a preemption process weighed down with standards that have no place in the reinsurance regulatory world - to wit, the effect of covered agreements on individual consumers. Reinsurers are not and never have been a vehicle for consumer protection. State law has for decades recognized this fact by exempting reinsurers from consumer-related requirements. Rather, reinsurers play a key role in supporting the financial strength of insurers to help *insurers* sustain the financial wherewithal to protect the consuming public.

Instead of the standards for covered agreements and preemption set forth in the Dodd-Frank legislation, appropriate standards for entering into covered agreements should be established based on prudential considerations and the need to achieve/maintain a level playing field between U.S. and non-U.S. reinsurers. Once established, those standards should guide future covered agreements, which should be subject to appropriate review and comment prior to finalization. All states should be required to abide by the covered agreements not be shielded by onerous and cumbersome procedural safeguards layered over more procedural safeguards. Inconsistency alone should result in preemption because the balance of interests with respect to favorable treatment should have been part of the standards considered before entering into the covered agreement in the first instance.

Congressional Reports and Studies

Numerous annual and other reports are required to be made to Congress. Among them are reports regarding

- Any actions regarding preemption of inconsistent State insurance measures (annual);

- The insurance industry, generally, and any other information the Director of the FOI deems relevant (annual);

- The breadth and scope of the global reinsurance market and the critical role such market plays in supporting insurance in the U.S.;

- The impact of Part II of the Nonadmitted and Reinsurance Reform Act of 2010 on the ability of State regulators to access reinsurance information; and

- How to modernize and improve the system of insurance regulation in the U.S.

The reports and studies must take into consideration numerous factors identified in the Act too numerous to enumerate here.[24]

Nonadmitted and Reinsurance Reform Act of 2010 - Part II, Reinsurance

Title V, Subpart B, Part II, of the Act is virtually identical to the provisions introduced since the 109th Congress in the various versions of the Nonadmitted and Reinsurance Reform Acts of 2006 through 2010. [25]

The Act provides for the following with regard to reinsurance contracts:

- Credit for reinsurance is determined by the ceding insurer's state of domicile (as long as that state is NAIC accredited or the equivalent); and

- Laws and other measures of non-domiciliary states are preempted to the extent they restrict or eliminate arbitration rights, specify a particular state's law as the governing law of the contract or dispute under the contract, attempt to enforce the reinsurance contract on laws other than those specified in the reinsurance contract, or otherwise apply the laws of the non-domiciliary state to the reinsurance agreements of ceding insurers not domiciled in that state.

From its inception in 2006, this legislation was designed to counteract the extraterritorial application of state laws. For years, approximately 13 states have applied their laws in this manner through the denial of financial statement credit. Although most state credit for reinsurance laws are limited in application to domestic ceding insurers, some are not. In other situations, though state laws have been changed to so limit the state's authority, Departments of Insurance have seen fit to utilize other provisions of their law to reach non-domestics -- California provides the best example of this practice. Utilizing the statutory reference to "hazardous condition,"[26] as well as several other statutory hooks, the Department has for decades interpreted their authority in an expansive and often inconsistent and conflicting manner with cedents' domiciliary states

.

While the elimination of this extraterritorial practice has been characterized as "reinsurance reform," it is more useful to ceding insurers than it is to reinsurers. While cedents will be able to look to the laws of their domiciles as controlling, in terms of their reinsurance contracts, reinsurers (and their contracts) will continue to be subject to the laws and regulations of every state in which their cedents are domiciled. Even ceding insurers may continue to encounter difficulties, however, because there is no enforcement mechanism afforded in the new law, leaving insurers with no form of redress except filing suit against the offending state.

The Act provides for the following with respect to reinsurers:

- A reinsurer's domiciliary state is solely responsible for regulating the financial solvency of the reinsurer (as long as that state is NAIC accredited or the equivalent); and

- A non-domiciliary state may not require additional financial information other than the information the reinsurer is required to file with its domiciliary state.

Some states have for years followed a practice of requiring companies to restate their financials based on individual state requirements. From its inception, this legislation was designed to prevent that from happening in the future. While the new law retains the state system of regulating reinsurers (as opposed to federal), it is intended to create something more akin to a single state regulator for reinsurers. This characterization, however, has its limits. In order to be eligible for financial statement credit, reinsurers will continue to have to be licensed or otherwise authorized on a state-by-state basis.

Impact of Dodd-Frank on Reinsurance Regulatory Equivalency

Ironically, some of the reforms suggested by state regulators in the NAIC Framework would have gone further down the road toward reinsurance regulation reform than the long-awaited federal legislation embodied in Dodd-Frank. The NAIC would have provided a mechanism whereby both U.S. and non-U.S. reinsurers could be licensed or otherwise authorized in a single state and provide credible reinsurance throughout the country.[27] Certainly, this would be the effect of an optional federal charter.

In fact, the battle lines for the continuing effort toward creating an optional federal charter have already been drawn. Representative Barney Frank, Chair of the House Financial Services Committee, recently announced to state regulators that an optional federal charter will definitely be on the 2011 congressional agenda because it has strong bipartisan support. Reinsurers are the obvious and most logical sector of the industry that should be given this option. Typically global in nature, for the reasons discussed earlier in this article, reinsurers are prevented from competing on a level playing field with their global counterparts when they continue to be subject to state regulation. As discussed in this article, the reinsurance contract reforms contained in Dodd-Frank provide greater relief to ceding insurers than to reinsurers. Likewise, while the reinsurer portion of Title V, Part B provides a single state regulator for purposes of financial solvency, reinsurers must still, as a practical matter, be licensed or otherwise authorized on a state-by-state basis.

At a time when the European Union has a single passport for reinsurers domiciled in EU member states, when individual countries and regions of the world are seeking the ability of their domiciled reinsurers to assume business in the United States on the basis of a single authorization or recognition - policymakers need to understand that regulatory recognition must begin at home.

We aren't there yet.

Endnotes:

[1] Debra J. Hall, Credit for Reinsurance: An On-Going Regulatory Debate, in REINSURANCE: FUNDAMENTALS AND NEW CHALLENGES 127, AT 128 (hereinafter "FUNDAMENTALS").

[2] *See generally*, Robert M. Hall and Debra J. Hall, Changes in Credit for Reinsurance Laws, Int'l J. of Ins. Law, p. 4, 257 (1995) (hereinafter "Changes").

[3] Issues included the amount of capital and surplus beyond the funding of liabilities; whether all multiple beneficiary trusts should be held on a joint, not several, basis; and net v. gross funding of the trust. With respect to the latter issue, an audit of the Lloyd's American Trust Fund revealed that it was $18.5 billion deficient on a gross basis, because it was funded net (instead of gross) of reinsurance. This ultimately resulted in the creation of multiple trusts with the forward-looking one funded on a gross basis, as the law had required. *See generally*, Report of *Examination of Lloyd's of London* as of December 31, 1993, New York Insurance Department, May 11, 1995.

[4] The ILU provision has subsequently been deleted from the NAIC Models.

[5] As of 1995, approximately 13 states departed from the NAIC Models by applying their laws to insurers licensed (not just domiciled) in their state. The practical effect was to require those insurers to re-calculate their annual statements based on that individual state's law; to include contract provisions not required by other states, including their state of domicile; or potentially, to write business in that state through a separate company.

[6] *See generally*, Robert M. Hall, Security Devices for Unlicensed Reinsurers, 16 Un. Of Pa. J. of Int'l Bus. Law 41 (Spring 1995).

[7] *See generally, Changes to Lloyds' Trust Funds: Considerable Improvement Noted*, Int'l J. of Ins. Law, p. 3 204 (1996).

[8] *See generally*, T. Darrington Semple Jr. and Robert M. Hall, *The Reinsurer's Liability in the Event of the Insolvency of a Ceding Insurer*, 21 Tort & Ins. L. J. (1986); Stephen W. Schwab, *et. al., Onset of an Offset Revolution; The Application of Set-offs in Insurance Insolvencies*, 95 Dick. L. Rev. 448 (1991), 8 J. Ins. Reg. 446 (1990), reprinted in 5 Nat'l Ins. L. Rev. 813 (1992) and VI Insurance Law Anthology 107 (1992). (Note Debra J. Hall was a co-author of this latter set of publications, known at the time, as Debra J. Anderson.)

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

[10] *Changes* at 1.

[11] Following the publication of *Failed Promises*, Congressman John Dingell (D-MI), then Chairman of the House Committee on Energy and Oversight, introduced H.R. 4900, followed shortly thereafter by H.R. 1290, which would have created a means for transferring the regulation of reinsurance from the states to a Federal Commission. H.R. 1290 provided for the certification of professional reinsurers and the reinsurance departments of primary insurers. It would have provided "one stop shopping" for a U.S. reinsurer to assume risks throughout the United States. Known as the Federal Insurance Solvency Act of 1993, the legislation also addressed issues relevant to primary insurers and brokers. Later, Chairman Dingell drafted a so-called "mini" bill, the "Federal Interstate Insurance Solvency Act of 1994" with continued focus on reinsurance regulation reform. The NAIC responded to these developments by creating a proposed Non-U.S. Insurer Act, which would have established the NAIC 's Non-Admitted Insurers Information Office as a "gatekeeper" for permitting non-U.S. reinsurers to assume business in the United States.

See National Association of Insurance Commissioners, Report of the Executive (EX) Committee, 1A: 136 (1993). *See also*, FUNDAMENTALS at 133-136.

12 The National Insurance Act of 2007, S.40, was reintroduced in the Senate on May 24, 2007 and referred to the Committee on Banking, Housing and Urban Affairs. Like its predecessor, this legislation would have created a federal charter for insurers and reinsurers, using the dual-charter system in the banking industry as a model. On April 2, 2009, Representatives Royce and Bean introduced H.R. 1880, the National Insurance Consumer Protection Act which would establish an optional federal charter for insurers and reinsurers. The bill was referred to the House Energy and Commerce Committee.

13 The Nonadmitted and Reinsurance Reform Act was reintroduced in the 110th Congress, as H.R. 1065, and passed by the House on June 25, 2007. Though referred to the Committee on Banking, Housing, and Urban Affairs, the legislation never advanced in the Senate. Similar legislation, also the Nonadmitted and Reinsurance Reform Act of 2007, S. 929, was introduced in the Senate on March 20, 2007, and referred to the Committee on Banking, Housing, and Urban Affairs. On May 21, 2009, H.R. 2571, the Nonadmitted and Reinsurance Reform Act of 2009 was reintroduced. But this time it was passed by the House of Representatives on September 9, 2009 and referred to the Senate Committee on Banking, Housing, and Urban Affairs. S. 1363, the Nonadmitted and Reinsurance Reform Act of 2009, was also introduced in the Senate and referred to the Committee on Banking, Housing and Urban Affairs.

14 On May 21, 2009, H.R. 2609, the Insurance Information Act of 2009 was reintroduced and reported by Committee on December 2, 2009.

15 The President, with the authorization or approval of Congress, is vested with the power to make international agreements dealing with any matter that falls within the powers of Congress or the President under the Constitution. The Trade Agreements Act of 1979 (TAA) was revised to

specifically provide the United States Trade Representative (USTR) with "responsibility for coordinating United States discussions and negotiations with foreign countries for the purpose of establishing mutual recognition arrangements with respect to standards-related activity."

16 The Foreign Affairs Doctrine vests exclusive power over foreign policy with the federal government. The U.S. Supreme Court has made clear that "[p]ower over external affairs is not shared by the States; it is vested in the national government exclusively." *United States v. Pink*, 315 U.S. 203, 233 (1942). States cannot negotiate treaties or bilateral trade agreements with foreign governments, because the U.S. Constitution confers treaty-making power and responsibility for conducting foreign affairs on the President and Executive Branch. U.S. Constitution, art. II, §2.

17 Similar to the Foreign Affairs doctrine, the Foreign Commerce clause vests Congress with the power to "regulate Commerce with foreign nations." U.S. Constitution, art. I, §8, cl. 3.

18 The Constitution specifically provides that "[n]o State shall enter any Treaty, Alliance, or Confederation," and further provides that "[n]o State shall, without the Consent of Congress,…enter into any Agreement or Compact…with a foreign Power." U.S. Constitution, art. I, §10, cls. 1 and 3. In other words, states may enter into "agreements" or "compacts" with foreign governments only with the consent of Congress. The NAIC proposal, however, purported to give the NAIC and states the power to enact an agreement with foreign sovereigns without any statutory authority or other indication of consent by Congress to grant such power. While the McCarrran-Ferguson Act leaves insurance regulation generally to the states in the area of commerce power, it does not in any way indicate implicit consent to enter into agreements with foreign sovereigns.

19 IAIS Guidance Paper on the Mutual Recognition of Reinsurance Supervision, October 2008, at 4.

[20] *Id.*

[21] Section 314 makes it clear that the Treasury Secretary and the USTR have joint authority for negotiating and entering into covered agreements on behalf of the United States. This section also provides a detailed process of prior notice that must be given before such negotiations are underway, the scope of the proposed agreement, notice of the proposed agreement once it has been negotiated, and a layover provision of 90 days for comment and review.

[22] *See* n. 21.

[23] Dodd-Frank retains the more cumbersome requirements emanating from the House bill.

[24] *See* the Act at p. 211.

[25] Refinements regarding state tax exceptions and assessments were made in the intervening years.

[26] *See* California Ins. Code §1065.1.

[27] Currently, those non-U.S. reinsurers that provide collateral through a multiple beneficiary trust, can be described as coming the closest to operating in this manner in the United States.

Information for Contributors

The IRU encourages and welcomes articles from industry professionals on topical issues of potential interest to the Journal's readership.

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