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# Financing XXX Reserves for the Long Term: Focus Turns to Letters of Credit

*by Thomas E. McGuinness, Alexander R. Cochran and Christopher J. Ray*

In the year 2000, the National Association of Insurance Commissioners (the "NAIC") promulgated the Valuation of Life Insurance Policies Model Regulation, commonly known as "Regulation XXX." The rapid adoption of Regulation XXX by the states has left many life insurers and reinsurers in the U.S. grappling for most of the current decade with the more conservative reserving methodologies for level premium term life insurance business required by Regulation XXX and its attendant strain on surplus. Likewise, the promulgation of Actuarial Guideline 38 ("AG38" or "Regulation AXXX"), beginning in 2002, has had similar consequences for life insurers and reinsurers with respect to reserves for universal life insurance policies with secondary guarantees.

To address the funding of the portion of reserves on business subject to Regulation XXX or AG38, calculated on a statutory accounting basis, in excess of reserves determined on an economic basis ("excess reserves"), many insurers and reinsurers in the U.S. have pursued long-term structured finance solutions, including fully funded securitizations as well as unfunded letter of credit-based solutions. Before the current credit crisis, life insurers and reinsurers increasingly began to explore capital markets-based reserve financing solutions involving the securitization of defined blocks of business subject to Regulations XXX or AXXX. In these types of transactions, the defined block would typically be reinsured to a newly formed, special purpose captive reinsurer, and the excess reserves would be funded with the proceeds of debt securities issued to the capital markets. The debt securities would be repaid from the cash flows of the defined block of business as the excess reserve requirement decreased over time. The debt securities issued in these reserve financing securitizations were typically wrapped by a financial guaranty insurer, but generally were without recourse to the sponsoring insurer or its affiliates (other than the captive reinsurer).

While the recent economic downturn and turmoil in the credit markets has stifled the market for the insurance-linked securities that are key to a funded Regulation XXX or AXXX reserve financing, unfunded, letter of credit-based reserve financing solutions remain a viable option for life insurers in the U.S. For example, in the second half of 2008, we saw multiple letter of credit-based long-term reserve financing transactions in excess of one billion dollars.

## Transaction Structures

Structures for letter of credit-based reserve financings vary from transaction to transaction. Typically, however, they involve the formation of a special purpose captive reinsurer in a jurisdiction with a favorable regulatory regime, either onshore (for example, Vermont or South Carolina) or in an offshore jurisdiction. The captive reinsurer will usually be capitalized and owned either by the sponsoring insurer or by one of its affiliates. The defined block of business subject to Regulation XXX or AG38 will then be coinsured from the U.S. domestic life insurer or reinsurer (the "ceding insurer") to the newly-formed captive reinsurer.

The captive reinsurer will enter into a credit facility with a bank qualified to issue letters of credit under applicable reinsurance credit laws and regulations (the "issuing lender"). Under the credit facility, letters of credit meeting applicable credit for reinsurance requirements will be issued by the issuing lender for the benefit of the ceding insurer. In most structures, an affiliate of the ceding insurer, usually its corporate parent, will be a party to the credit agreement or will enter into a separate agreement with the issuing lender, obligating the parent to reimburse the issuing lender for any draws under the letter or letters of credit not reimbursed by the captive reinsurer. Thus, unlike many of the

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## WHAT'S INSIDE

# Letter from the Editor

The world financial markets witnessed tremendous turmoil and unprecedented government interventions in 2008, fundamentally altering the landscape in which insurance companies and other financial institutions do business. This landscape continues to evolve in dramatic ways in 2009. As this issue of the *Debevoise & Plimpton Financial Institutions Report* goes to press, the new administration in the U.S. continues to develop the financial stability plan first announced by the Treasury Secretary in early February. Committees are holding hearings on Capitol Hill on the causes of the financial crisis, the nature of systemic risk and the potential for sweeping regulatory reform. There will continue to be calls for a single regulatory supervisor, probably the Federal Reserve, to address systemic risk and financial stability for all major financial institutions, including insurance groups that today have no federal supervisor. This will reignite discussion of federal regulation of the insurance companies themselves. The contours of the U.S. regulatory overhaul that may ultimately result remain uncertain. Meanwhile, regulators around the world address similar issues. Preparations continue for the Group of 20 summit to begin in London on April 2, where the agenda will include international cooperation among regulators in the supervision of financial institutions.

In this issue, we address a handful of significant, ongoing changes to the economic and regulatory environment, such as the move by the U.S. Securities and Exchange Commission toward international accounting standards and the European Union's proposal to regulate credit rating agencies. Also in this issue, we discuss the renewed focus by life insurers on the use of letters of credit to finance long-term reserving obligations, a transaction that can provide much-needed capital relief in this difficult economic climate.

As always, we will continue to monitor and report on these and other developments in the *Debevoise & Plimpton Financial Institutions Report* and in Client Updates.

Wolcott B. Dunham, Jr.
Editor-in-Chief

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# The SEC's Proposed IFRS Roadmap: Towards a Global Set of Accounting Standards or a "Race To The Bottom?"

*by Matthew E. Kaplan and Paul M. Rodel*

Just months after the U.S. Securities and Exchange Commission (the "SEC"), under then Chairman Christopher Cox, published a long-awaited proposed Roadmap for adoption of International Financial Reporting Standards by U.S. issuers, the outlook for the proposal has changed significantly.

On November 14, 2008, the SEC published for public comment a proposed "Roadmap" that would lead to mandatory use of International Financial Reporting Standards as issued by the International Accounting Standards Board ("IFRS") instead of U.S. GAAP by the largest U.S. issuers (i.e., reporting companies) in their 2014 annual report on Form 10-K and by all U.S. issuers in their 2016 annual report on Form 10-K. Under the Roadmap, the SEC would vote in 2011 whether to require use of IFRS by U.S. issuers with respect to their periodic reporting under Sections 13 and 15(d) of the Exchange Act, proxy and information statements under Section 14 of the Exchange Act and registration statements under Section 12 of the Exchange Act and Section 7 of the Securities Act.

But that was under Chairman Cox. Enter new Chairman Mary Schapiro, who in her Senate testimony on January 15 said of the SEC's November 2008 proposed Roadmap: "I would pursue [the Roadmap] with great caution so that we don't have a race to the bottom." Ms. Schapiro cited concerns about the relative lack of detail in IFRS compared to U.S. GAAP, the potential for inconsistent application and enforcement across jurisdictions, high transition costs and, most importantly, the independence of the IASB and the rigor of its standard-setting processes. Wrapping up her remarks on the Roadmap, Ms. Schapiro said: "So I will tell you that I will take a big deep breath and look at this entire area again carefully and will not necessarily feel bound by the existing Roadmap that's out for comment."

In light of Chairman Schapiro's testimony and the growing number of pressing issues on the SEC's agenda, it is at best unclear where the Roadmap goes from here. In the interim, however, it makes sense to take stock of the proposed Roadmap and the series of critical milestones it sets out before the SEC would decide whether to adopt IFRS for U.S. issuers. The Roadmap is available at http://sec.gov/rules/proposed/2008/33-8982.pdf.

## Milestones Prior to IFRS Reporting by U.S. Issuers

The Roadmap sets out seven milestones which, if achieved, could lead to the use of IFRS by all U.S. issuers:

- Improvements in IFRS such that it becomes a set of comprehensive, high-quality accounting standards.
- Creation of a secure, stable funding mechanism for the International Accounting Standards Committee ("IASC"), the body that oversees the International Accounting Standards

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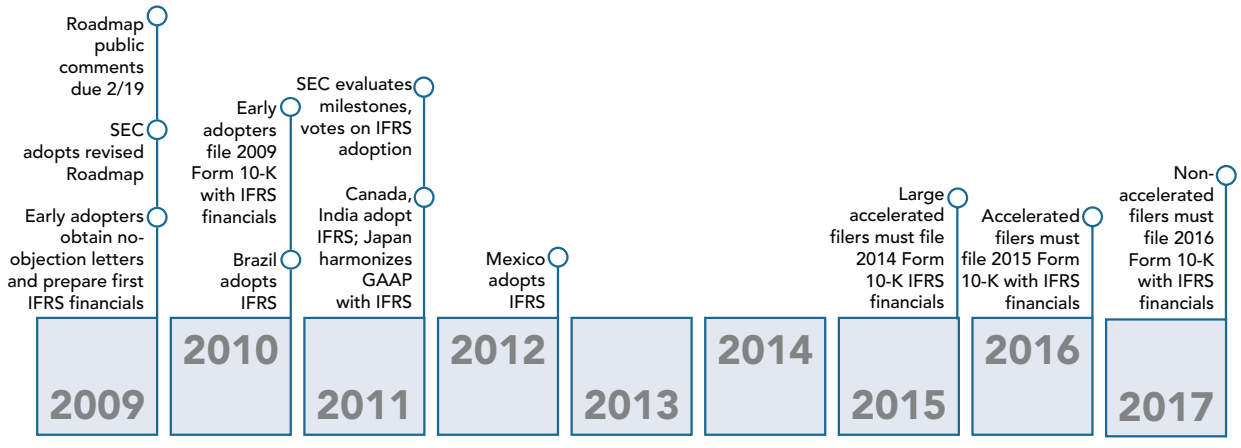
**Proposed IFRS Roadmap for U.S. Issuers**



# IFRS Roadmap

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Board ("IASB"), that permits the IASC to function independently and enhances the IASB's standard-setting process.

- Development of more detailed taxonomies for interactive reporting of IFRS data, including using Extensible Business Reporting Language, or XBRL.
- Effective education and training about IFRS for investors, accountants, auditors and others involved in the preparation and use of financial statements.
- Limited voluntary, early use of IFRS to enhance the comparability of financial reporting by the largest U.S. issuers with the largest non-U.S. companies in the same industry and to broaden awareness of IFRS.
- Expected vote in 2011 by the SEC whether to require use of IFRS by U.S. issuers.
- Potential staged implementation, beginning with respect to fiscal years ending on or after December 15, 2014, of mandatory use of IFRS based on an issuer's status as a large accelerated filer, accelerated filer or non-accelerated filer.

## Anticipated Timing

If adopted as proposed, the Roadmap's timeline would be more aggressive than it might at first appear. The early adopters described below would prepare IFRS financial statement disclosure with respect to fiscal 2009, i.e., this year, and the SEC would vote whether to adopt IFRS for use by U.S. issuers in three years. On the prior page is an overview of the timing of key dates related to the proposed Roadmap.

## Early Adoption by Selected Large U.S. Issuers in IFRS Industries

As indicated in the timeline, certain U.S. issuers would be eligible to use IFRS beginning in their annual report filed in 2010, i.e., with respect to fiscal 2009, if the company is one of the 20 largest companies in its industry by market capitalization on a global basis and IFRS is used as the basis of financial reporting more often than any other basis of accounting by the 20 largest companies in the industry. In order to participate in the pilot program, a U.S. issuer would be required to make a submission to the SEC demonstrating that the company meets the eligibility criteria and to obtain a no-objection letter from the staff of the SEC in response to the submission. The SEC estimates that approximately 110 large companies in 34 global industries (based on a total of 74 industries under Standard Industrial Classification, or SIC, codes) will be eligible to participate in its IFRS early adoption program upon obtaining a no-objection letter from the SEC. Obtaining a no-objection letter would not commit the issuer to use IFRS. We note that even if a U.S. issuer is not eligible to participate in the early adoption program, the Roadmap would not prohibit a U.S. issuer from providing supplemental IFRS information in its public disclosure.

**The SEC estimates that approximately 110 large companies will be eligible to participate in its IFRS early adoption program.**

An eligible U.S. issuer that elects to file IFRS financial statements with the SEC would be required to file three years of audited financial statements prepared under IFRS and the initial filling must be made in its annual report on Form 10-K (i.e., not a quarterly report, Securities Act or Exchange Act registration statement or proxy or information statement). In addition, an eligible U.S. issuer that is a first-time adopter of IFRS would provide the reconciliation and disclosure required by IFRS 1 "First-Time Adoption of IFRS."

The SEC has not yet determined what IFRS/U.S. GAAP reconciliation disclosure it will require of eligible early adopters of IFRS. The proposed Roadmap presents two alternatives: "Proposal A – Reconciled Information Pursuant to IFRS 1" and "Proposal B – Supplemental U.S. GAAP Information." Under Proposal A, an early adopter would provide the reconciling information from U.S. GAAP to IFRS required by IFRS 1 as a footnote to the early adopter's audited financial statements included in its annual report on Form 10-K. After the initial reconciliation, an early adopter would not be required to provide any reconciliation in future SEC filings. Under Proposal B, an early adopter would provide the IFRS 1 reconciliation required in Proposal A and would provide, on an annual basis, unaudited reconciliation from IFRS to U.S. GAAP covering the three years of IFRS financial statements in the "Business" section of its annual report on Form 10-K. The unaudited reconciliation would, like all other information in an issuer's "Business" section, be considered "filed" for purposes of Exchange Act Section 18, would be subject to Sarbanes Oxley Sections 302 and 906 certifications and would be subject to disclosures and certifications relating to disclosure controls and procedures. The unaudited reconciliation would not, however, be subject to Sarbanes Oxley Section 404 management assessment of, or the auditor's report relating to, internal controls and

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procedures over financial reporting and would not be required to be audited or reviewed by auditors.

## IFRS: The Basics

IFRS is a stand-alone set of financial reporting standards set by the IASB, an independent accounting standards body based in London. The IASB consists of 14 members from nine countries, including the United States. The IASB began operations in 2001, when it succeeded the International Accounting Standards Committee, and is funded by contributions from major accounting firms, private financial institutions and industrial companies, central and development banks and other international and professional organizations throughout the world. As of February 2009, more than 110 countries, including all European Union member states, require or permit IFRS reporting and approximately 87 of those countries require IFRS reporting for all domestic-listed companies.

In general terms, U.S. GAAP is considered a rules-based set of standards, while IFRS is considered more principles-based and, therefore, subject to more interpretation. So, for example, we understand that IFRS fits into one book, about two inches thick. By comparison, the FASB paperbacks of pronouncements, plus the paperback version of the FASB Emerging Issues Task Force consensuses, stack up about nine inches high, without including the U.S. authoritative accounting literature. According to research by the American Institute of Certified Public Accountants, key differences between U.S. GAAP and IFRS include:

- IFRS does not permit Last In First Out (LIFO) as an inventory costing method.
- IFRS uses a single-step method for impairment write-downs rather than the two-step method in U.S. GAAP, making write-downs more likely.
- IFRS has a different probability threshold and measurement objective for contingencies.
- IFRS does not permit curing debt covenant violations after year-end.
- IFRS guidance regarding revenue recognition is less extensive than U.S. GAAP and contains relatively little industry-specific instruction.

IFRS has figured prominently on the SEC's reform agenda over the past several years. Since March 2007, the SEC has held three roundtables to examine use of IFRS by U.S. and non-U.S. companies and in August 2007 the SEC issued a concept release on allowing U.S. issuers to prepare financial statements using IFRS. Most recently, the SEC adopted rules, effective March 2008, permitting foreign private issuers to file with the SEC financial statements prepared in accordance with IFRS without reconciliation to U.S. GAAP.

## Other Significant Considerations

In addition to the seven milestones discussed above, the Roadmap discusses a handful of significant "other considerations" relevant to the proposed transition to IFRS. For instance, changes in accounting standards for documents filed with the SEC are likely to affect financial reporting to other parties, including bank regulators (e.g., in measuring compliance with capital adequacy and liquidity requirements), the IRS and other tax authorities, ratings agencies, and lenders and bondholders under lending documentation and indentures. Changing accounting standards will also require changes in an issuer's policies and procedures and system of internal controls.

As discussed above, IFRS has a smaller volume of interpretive literature than U.S. GAAP and in some cases provides for a greater number of options than does U.S.

**In general terms, U.S. GAAP is considered a rules-based set of standards, while IFRS is considered more principles-based and, therefore, subject to more interpretation.**

GAAP. While this flexibility may in some instances allow financial statements to more closely reflect the economics of a transaction or event (and thereby improve the quality of financial reporting), it could also reduce comparability of reported information if issuers use this flexibility to account for similar transactions or events in different ways. Finally, and perhaps most fundamentally, a transition to IFRS reporting by U.S. issuers would reduce the influence of U.S. capital market participants and the SEC on the accounting standard setting process, as IFRS standards are set by the IASB in London in response to "broad, world-wide constituencies" representing "a wide range of interests, reflecting varying economic, social and political environments." ■

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# Proposed EU Regulation of Credit Rating Agencies

*by Edite Ligere*

Over the past eighteen months, the world has witnessed one of the most uncertain episodes in financial history. A factor that makes the present crisis different from those we have seen before is that this is the first major global boom and bust of securitised credit instruments. The role of credit rating agencies ("CRAs") in the financial markets is significant, and has been the subject of heightened focus by legislators, regulators and other interested parties seeking financial regulatory reform. CRAs such as Standard & Poor's, Moody's and Fitch are recognised in the EU as External Credit Assessment Institutions under Basel II and are involved in assessing the risks associated with assets held by financial institutions which are subject to capital adequacy requirements. In the U.S., the Securities and Exchange Commission has used credit ratings from "nationally recognized statistical rating organizations" since 1975 for various purposes, including, among other things, in connection with regulatory capital requirements applicable to broker dealers. The U.S. undertook reforms to increase regulatory oversight of CRAs in 2006, and more recently has been considering additional changes to the CRA regulatory regime. Despite their importance to the functioning of the financial markets, CRAs are currently subject to EU law only to a very limited extent. It is not surprising, therefore, that the EU has proposed new and important regulation of CRAs as a part of its effort to address the ongoing financial crisis. This article gives a brief summary of the EU legislation currently applicable to CRAs and considers the EU Commission's draft Regulation (2008/0217 COD) which seeks to regulate CRAs whose ratings are used by financial institutions.[1]

## Current CRA Regulation in the EU

In the EU, CRAs are independent bodies in the form of private companies. They are subject to various voluntary codes of conduct and policies, such as the International Organisation of Securities Commissions CRA Code which provides for independence, objectivity, analytic integrity and openness. The Committee of European Securities Regulators ("CESR") currently performs a supervisory role in relation to CRAs operating in the EU, monitoring compliance with the International Organization of Securities Commissions ("IOSCO") CRA Code. At present, CRAs are not subject to specific legally binding regulation. That said, certain of the Financial Services Action Plan Directives, such as the Markets in Financial Instruments Directive (the "MiFID")[2] , the Capital Requirements Directives (the "CRD")[3] , and the Market Abuse Directive[4] , apply to CRAs.

Under the MiFID, for example, while issuing a credit rating will not normally result in a CRA providing investment advice, a CRA providing investment services on a professional basis may require authorisation. Under the CRD, among other things, CRAs' ratings must be objectively and independently assigned and reviewed on a continuing basis (though the CRD does not provide for any conduct of business requirements for CRAs). The Market Abuse Directive, however, is the most important of the three Directives as far as CRAs are concerned. Credit ratings do not amount to investment recommendations within the meaning of the Directive. However, the Market Abuse implementing Directive recommends that CRAs consider adopting internal policies and procedures designed to ensure that credit ratings published by them are fairly presented and that they disclose any significant interests or conflicts of interest relating to the credit rating. No legal requirement is imposed on CRAs as a result of this recommendation, and there is no means of monitoring whether or how CRAs seek to comply with the recommendation.

## Proposed EU Regulation of CRAs

On 12 November 2008 the EU Commission published a draft regulation (2008/0217 COD) which seeks to regulate CRAs whose ratings are used by financial institutions (the "Regulation"). The draft Regulation provides for a single registration of CRAs throughout the EU. It sets out detailed rules covering both the registration and supervision of CRAs and the disclosure of methodologies used by them. Since EU Regulations (as opposed to EU Directives) do not require transposition into national law by Member States in order to become effective, once the draft Regulation is adopted at the EU level, it will create a pan-European CRA regulatory framework.

## Objectives of the Draft Regulation

The draft Regulation has four key objectives. First, the Regulation seeks to ensure that CRAs avoid conflicts of interest in the rating process, or at least manage conflicts efficiently. This is achieved by a requirement that CRAs have an administrative or supervisory board that is responsible for ensuring:

- the independence of the rating process;
- that conflicts of interest are properly identified, managed and disclosed; and
- compliance of CRAs with the requirements of the Regulation.

Second, the Regulation is intended to improve the quality of the methodologies

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used by CRAs. Third, the Regulation aims to increase transparency by increasing disclosure obligations. Fourth, the Regulation seeks to introduce an efficient registration and surveillance framework that will minimize "forum shopping" and regulatory arbitrage between EU jurisdictions.

## Scope of Application

The Preamble to the draft Regulation recognises that most CRAs have their headquarters outside the EU. Yet, credit institutions, investment firms, insurance, assurance and reinsurance undertakings, amongst other financial institutions, may, for regulatory purposes, only use credit ratings which are issued by CRAs "established" and registered in the EU. The Regulation does not define "established." Under the draft Regulation, CRAs that do not provide ratings for regulatory purposes do not appear to have to be established in a Member State; they must merely be registered.

CRAs operating in the EU before the entry into force of the Regulation will be required to adopt all necessary measures to comply with the Regulation. They will also have to apply for registration within six months of the Regulation entering into force. If registration is refused, the CRA/CRAs in question will have to cease issuing credit ratings.

## Disclosure Obligations

CRAs will be obliged to disclose to the public the methodologies, models and key assumptions used in the rating process. If the CRA changes its rating methodology, it must immediately disclose which ratings are likely to be affected by this change and re-rate them promptly. The draft Regulation obliges CRAs to disclose ratings on a non-selective basis and in a timely manner, unless the ratings are only distributed to subscription holders. A CRA may not charge a fee for complying with its obligations under the Regulation.

In addition, CRAs must periodically disclose data on the historical default rates of rating categories and provide a list of the largest 20 clients by revenue. CESR is to create a publicly available central repository for such data. CRAs must also publish an annual transparency report and maintain records of their activities.

## The Registration Process

Oddly, although it is the competent authority of the home Member State which decides whether to grant or refuse the application for registration (and may charge a fee for doing so), applications for registration are to be submitted to CESR. If submitted by a group of affiliated CRAs, the group must mandate one of the members of the group to submit the application to CESR on its behalf. Within 10 days of receipt of the application, CESR must transmit it to the competent authority of the home Member State and inform the competent authorities of the other Member States of that transmission.

Upon receipt of a complete application the competent authority of the home Member State must transmit the application to the competent authorities of the other Member States and CESR. This applies regardless of whether the CRA in question operates in any of the other Member States. Within 40 days of receipt of the complete application, the competent authority of the home Member State must communicate to CESR a reasoned draft registration or refusal decision. CESR is given the opportunity to provide its views within 15 days of receiving the draft decision. It may request re-examination of the competent home authority's draft decisions.

The competent authority of the home Member State must adopt its decision within 15 days of receiving CESR's opinion. If the competent authority of the home Member State departs from the CESR's opinion, it must give reasons for doing so. Where CESR gives no opinion, the competent authority of the home Member State must adopt its decision within 30 days of the draft decision being sent to CESR.

The competent authority of the home Member State must inform the CRA/CRAs concerned of its decision within 10 days of it being made and notify the EU Commission, CESR and the other competent authorities of the registration it has carried out. Within 30 days of the home Member State regulator making a decision to grant registration, the EU Commission must publish an updated list of CRAs registered in accordance with the Regulation in the Official Journal of the EU.

Three years after the coming into force of the Regulation, the EU Commission must publish a report on the reliance on credit ratings in the EU and the appropriateness of remuneration of CRAs by the rated entity. This report must be submitted to the European Parliament and the Council of the EU.

## The Role of the Committee of European Securities Regulators versus the Role of the Competent Authority of the Home Member State

The draft Regulation gives CESR a central coordinating, advisory and mediating role. It requires CESR to issue guidance on:

- the registration process and coordination arrangements between the competent authorities and CESR;
- enforcement practices and activities by the competent authorities; and

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- common standards on the presentation of the information that CRAs are required to disclose under the Regulation.

CESR is entrusted with the task of establishing a mediation mechanism to assist in finding a common view amongst the competent authorities of the Member States. It is required to publish an annual report on the application of the Regulation. CESR is also required to cooperate, where appropriate, with the Committee of European Banking Supervisors and the Committee of European Insurance and Occupational Pensions Supervisors.

The competent authority of the home Member State supervises compliance with the Regulation and is responsible for imposing penalties for non-compliance. It may, amongst other things, withdraw the registration (not before providing a reasoned draft decision to CESR), impose a temporary prohibition of issuing credit ratings throughout the EU, suspend the registration, adopt measures to ensure that CRAs continue to comply with legal requirements, issue public notices when a CRA breaches the obligations set out in the Regulation or refer matters for criminal prosecution to the competent jurisdictions.

The competent authority of the home Member State is also responsible for laying down the rules on the penalties applicable to infringements of the provisions of the Regulation and ensuring that the Regulation is implemented. At a minimum, "effective, proportionate and dissuasive" penalties must be imposed in cases of gross professional misconduct and lack of due diligence.

It is possible for the competent authority of the home Member State to delegate any of its tasks under the draft Regulation to its counterpart in another Member State, subject to its agreement. However, delegation of tasks is not intended to affect the responsibility of the designated competent authority. Where a competent authority of a Member State has grounds for believing that a registered CRA acting within its territory is in breach of the Regulation, it must inform the competent authority of the home Member State. The informing authority can take specified measures against the registered CRA if the home regulator fails to or is not in a position to act.

The division of responsibilities in the draft Regulation between CESR's coordinating, advisory and mediation role and the role of the competent authority of the home Member State is somewhat confusing. Given that the competent authority of the home Member State decides whether to register a CRA and is ultimately responsible for deciding upon and imposing penalties, it is possible that some Member States will be seen by CRAs as more lenient and therefore preferable jurisdictions for registration.

The EU's proposals have attracted some criticism from market participants over the potential for financial protectionism and fragmentation of approach to the regulation of CRAs between the EU and the U.S. The International Capital Markets Association has raised concerns that the draft Regulation is likely to make the EU less competitive relative to the U.S. and Asia.

## Conclusion

The EU's current draft proposals on the regulation of CRAs are likely to attact increasing interest from financial institutions and other market participants. Although the proposals represent a useful starting point, many would argue that consistency of regulation at a global level is needed. National or regional measures may not be sufficient. Inevitable inconsistencies and the prospect of "forum shopping" are obvious risks of patchy regulation. The April 2009 G20 London summit may well set the tone for any future global regulation of the financial services industry. Time will tell whether there is sufficient political consensus for the regulation of CRAs at a global, or even a pan-European, level, but for now the draft EU Regulation is an interesting start. ■

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*1. See http://www.europarl.europa.eu/oeil/file.jsp?id=5714682.*

*2. See http://ec.europa.eu/internal_market/securities/isd/mifid_en.htm.*

*3. See http://ec.europa.eu/internal_market/bank/regcapital/index_en.htm#consultation.*

*4. See http://ec.europa.eu/internal_market/securities/abuse/index_en.htm.*

# Filings with and Approvals by State Insurance Regulators to Acquire Control of a U.S. Insurance Agent, Broker or Other Licensee

*by John Dembeck*

The following kinds of persons are licensed under many U.S. state insurance laws: agents, brokers, managing general agents ("MGAs"), reinsurance intermediaries, surplus lines brokers, third party administrators ("TPAs") and adjusters (collectively, the "Licensees"). Any given insurance industry M&A transaction may include the acquisition of a Licensee. A broker or an agent may acquire another broker or agent. An acquired life insurance group may include insurers together with an agent or a TPA. An acquired property/casualty insurance group may include insurers together with an agent or an MGA.

It is well known that all U.S. states require state insurance regulatory approval of an acquisition of control of a domestic insurer. These requirements, which are similar from state to state, are found in state insurance holding company laws. But these holding company laws do not apply to the acquisition of control of Licensees. This article describes certain filing and approval requirements applicable to the acquisition of control of Licensees.

## Prior Approval Laws – Texas

Since 2001, the Texas Insurance Code has required that a person make a filing disclosing certain information when it seeks to acquire control of an agent licensed in Texas, whether or not the agent is domiciled in Texas. Given the unique nature of this requirement, it can easily be overlooked. Under the Texas Insurance Code, The Texas Department of Insurance may disapprove the acquisition, after notice and a hearing, based on prescribed grounds of disapproval. The change of control is considered approved if the Department has not proposed to deny the requested change before the 61st day of receipt of the application. This Texas application is made on a special form found on the Department's website. In our experience, the Department typically indicates that it has no objection to the change of control well before the end of the 61-day deemer period. This same requirement applies to MGAs. Texas added a similar requirement for public adjusters in 2003 and for TPAs in 2007.

## Post-Closing Notice Laws

Some states require that notice be given to the state insurance regulator when a Licensee is acquired, sometimes within a specified time period (e.g., 30 days) from the date of the acquisition.

*TPAs.* Post-closing notice is typically required of an acquisition of control of a TPA because many state laws regulating TPAs are based on a version of the Third Party Administrator Statue adopted by the National Association of Insurance Commissioners (the "NAIC") and Section 11.G of this model law requires that a licensed TPA immediately notify the state insurance regulator of any material change in its ownership or control. If the TPA is licensed in 20 states that have this requirement, notice must be given in all 20 states.

*Public Adjusters.* Public adjusters are adjusters that represent an insured. The Public Adjusters Licensing Model Act adopted by the NAIC requires that a business entity submit an application using the NAIC Uniform Business Entity Application. That application requires disclosure of 10% owners (interest or voting interest) of a business entity or managers or members of a limited liability company. Section 9.C of this model law requires that the licensee inform the state insurance regulator of a change of information submitted on the application within 30 days of the change.

*Other Licensees.* In the case of agents, brokers, MGAs, reinsurance intermediaries, surplus lines brokers and independent adjusters (adjusters who represent insurers), there is no discernable pattern to state insurance law or regulation relating to post-closing notice requirements for the acquisition of control of the Licensee. This is probably in large part due to the fact that the NAIC model laws or guidelines on which many state laws regulating these Licensees are based do not require notice of an acquisition of control of the Licensee. Consequently, there are post-closing notice requirements in some states for some kinds of Licensees but not others.

Given the lack of uniformity of state laws, it may be prudent to give notice to the state insurance regulators of all states in which each Licensee that is being acquired is licensed. ■

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# Letters of Credit

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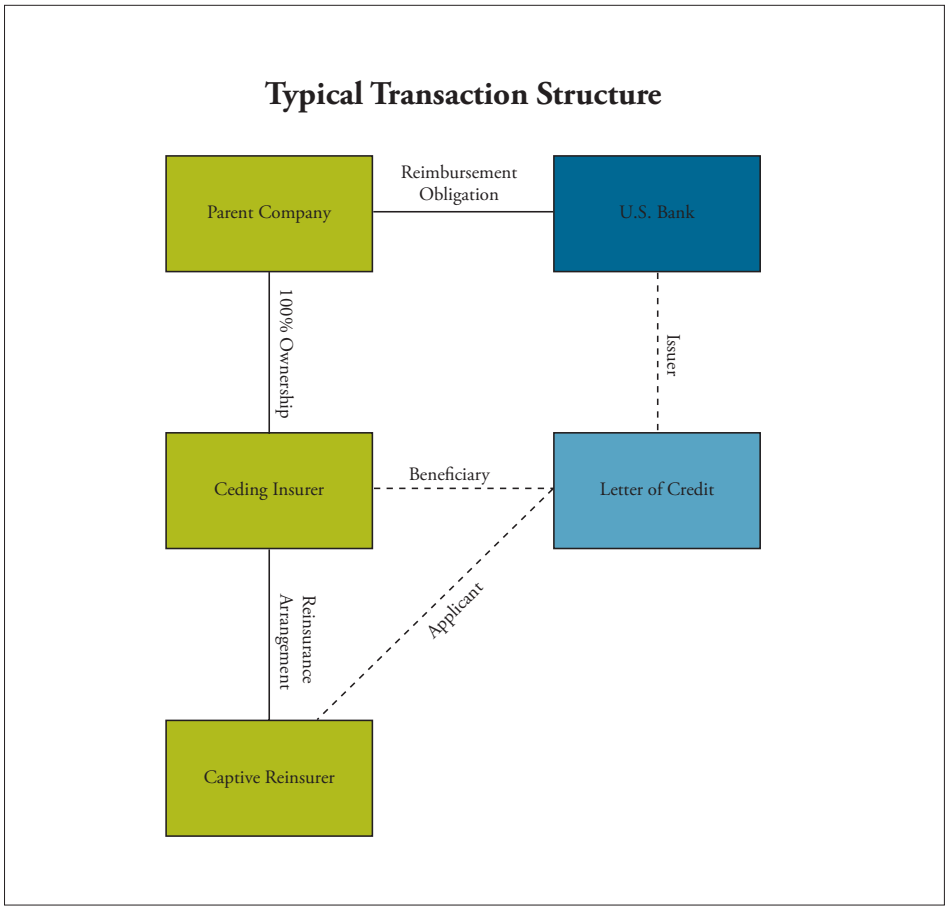


securitizations described above, letter of credit-based reserve financings typically provide the issuing lender with full recourse to the corporate parent of the ceding insurer (but not the ceding insurer itself) for reimbursement obligations under the credit facility.

Since the captive reinsurer in these types of structured transactions is generally not licensed or accredited by the ceding insurer's state of domicile, the coinsurance agreement will ordinarily obligate the captive reinsurer to provide collateral backing the full statutory reserves ceded under the coinsurance agreement in order for the ceding insurer to take full statutory financial statement credit for the reinsurance arrangement with the captive reinsurer. Collateral for the economic portion of the reserves on the effective date of the coinsurance is typically provided by the initial premium paid by the ceding insurer to the captive reinsurer under the coinsurance agreement, and held either by the ceding insurer on a funds withheld basis or placed in a reinsurance credit trust by the captive reinsurer. Collateral for the excess portion of the reserves is provided by the letter or letters of credit issued under the credit facility (see the accompanying diagram entitled "Typical Transaction Structure").

## Key Considerations

The parties negotiating a letter of credit-based reserve financing will encounter a number of important issues, many of which would be present in the negotiation of any credit facility, but several of which are unique to a Regulation XXX or AXXX reserve funding solution. The following discussion identifies and addresses a number of these key issues.

### *Letter of Credit Requirements*

Under most U.S. state credit for reinsurance regulations, a letter of credit provided as collateral for reinsurance to a reinsurer that is not authorized or accredited must meet certain specified requirements in order for the ceding insurer to take statutory financial statement credit for the reinsurance arrangement. Among other requirements, a letter of credit must generally be irrevocable, unconditional and evergreen, not be subject to terms outside the letter of credit, be issued by a bank that is qualified to issue letters of credit under applicable state insurance laws, and have a term of at least one year.

These requirements have important consequences in the negotiation of a credit facility for a structured reserve financing. For example, the requirement that a letter of credit be irrevocable means that the issuing lender cannot revoke or cancel the letter of credit or force the ceding insurer to return the letter of credit during its term, even if the captive reinsurer or other parties to the credit facility have defaulted in their obligations to the issuing lender. Lenders thus look to protect themselves in a variety of ways, including by creating sophisticated cash flow models to monitor performance of the reinsured business, and by requiring collateral posting based on the performance of the business, the credit quality of the parent guarantor or other factors. In addition, credit agreements typically require full collateralization of the undrawn portion of the letter of credit upon a failure of the captive reinsurer to reimburse a draw on the letter of credit, or even upon any event of default under the credit facility.

The requirements that a letter of credit be unconditional and not subject to terms outside the letter of credit also have important consequences for lenders looking

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to mitigate their exposure under a letter of credit by negotiating provisions in the coinsurance agreement or other transaction docments relating to draws under the facility.

### *Term*

The length of the term of both the credit facility and the letter or letters of credit issued under it raise important issues for consideration. Insurers entering into a Regulation XXX or AXXX reserve financing will often seek a long-term solution for their Regulation XXX and AG38 excess reserve liabilities, which may have a 20-year or longer life, and credit facilities for letter of credit-based reserve financings executed in recent years have often had terms of 10 or even 20 years. Long-term credit facilities allow insurers to lock in pricing and avoid the uncertainties of the spot market for letters of credit. The insurance regulator in the captive reinsurer's domiciliary jurisdiction, in evaluating the captive reinsurer's business plan and deciding whether to grant necessary licenses, may also favor a long term solution which may give comfort that the captive reinsurer will have the wherewithal to meet its obligations under the coinsurance agreement. Long-term facilities, however, will likely involve more extensive actuarial and cash flow modeling, due diligence and negotiations. Parties sometimes agree to reset pricing in long-term facilities at certain intervals.

As noted above, state reinsurance regulations typically require that a letter of credit have a term of at least one year in order for a ceding insurer to receive statutory reserve credit. In many long-term facilities that have been executed in recent years, the letter or letters of credit issued have terms expiring on the expiration date of the credit facility itself. However, since under credit for reinsurance regulations the letter of credit must be irrevocable, the issuing lender may, even under a long-term facility, propose that the letter of credit have an initial term of one year, subject to renewal on an annual basis if certain conditions are met. This type of renewal feature may allow the issuing lender to mitigate against its credit risk under the facility. However, under the "evergreen" feature of the letter of credit, the issuing lender would generally need to notify the ceding insurer of its decision not to renew the letter of credit at least 30 days prior to the termination date. Thus the ceding insurer would have the opportunity to draw down the letter of credit prior to termination.

### *Reimbursement Obligation*

In the event of a draw on a letter of credit, the issuing lender will first look to the letter of credit applicant, typically the captive reinsurer, for a reimbursement of any amounts drawn. Letter of credit-based reserve financings are typically structured as full recourse transactions, where an affiliate of the ceding insurer (usually its corporate parent) will agree to guarantee the obligations of the captive reinsurer to reimburse the issuer of the letter of credit. The reimbursement obligation and related guarantee can take many forms, ranging from a relatively straightforward guarantee to more complex derivative transactions, with collateral posting requirements. On occasion, multiple forms of credit support may be utilized simultaneously. An alternative, less common, letter of credit-based reserve financing is a transaction in which the issuing lender would have limited or no recourse to an affiliate of the ceding insurer. In such a case, the issuing lender would look solely to cash flows received by the captive reinsurer under the reinsurance arrangement for a repayment of any unreimbursed draws on the letter of credit over time, putting the lender in a situation more akin to that of the financial guaranty insurers in a wrapped securitization transaction.

### *Make-Whole Fees for Early Termination*

In exchange for providing long-term financing for Regulation XXX or AG38 reserves, lenders often will insist that the credit facility provide for the payment of a fee in the event that the sponsoring insurer terminates the credit facility earlier than expected. This early termination fee usually consists of a payment of the present value of the fees the lender expected to receive over the term of the credit facility or through a certain date or period of time after the early termination. This early termination fee is often heavily negotiated. For example, sponsoring insurers will often want to negotiate exceptions to the obligation to pay early termination fees (or at least the full amount of such fees) in the event the letters of credit issued under the credit facility no longer provide credit for reinsurance under applicable insurance laws and regulations, the issuing lender is no longer qualified to issue letters of credit under such laws and regulations, or Regulation XXX or AG38, as applicable is repealed, or the reserves required thereunder are materially reduced.

### *Regulatory Considerations*

Letter of credit-based reserve financing solutions involve reinsurance agreements and often services, tax sharing or other agreements between the ceding insurer, the captive reinsurer and other affiliates of the ceding insurer. Thus, applications for approval or non-disapproval of these inter-affiliate transactions will usually need to be made with the ceding insurer's domiciliary insurance department under applicable insurance holding company act rules and regulations. Depending on the size and structure of the transaction, regulatory approvals may also be required in states that apply portions of their insurance laws extraterritorially to non-domestic licensed insurers, such as New York, California and Wisconsin. The jurisdictions in which these

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transactions would need to be filed can raise issues with respect to the transaction structure. For example, the issuing lender may want to require that the letters of credit be issued to the trustee of the reinsurance trust account established by the captive reinsurer for the benefit of the ceding insurer. However, this could be at odds with the laws and regulations of some states where letters of credit are not recognized as permissible trust assets, or are required to be held by the ceding insurer.

The choice of domicile of the captive reinsurer is also an important consideration. Captive reinsurers may be domiciled in a U.S. jurisdiction, such as Vermont or South Carolina, or in an offshore jurisdiction, such as Bermuda or Ireland. The choice of jurisdiction will depend on many factors particular to each transaction, including tax considerations and the level of capitalization desired for the structure. The size and scope of the licensing application (including the level of detail needed for the captive's business plan and projections) will often be affected by the choice of jurisdiction.

### *Syndication*

The issuing lender may want to limit its exposure by syndicating the letter of credit. This can be done as a back-end syndication where the insurer will still look to the issuing lender for the full amount of any draws and the issuing lender will then look to collect from its syndicate counterparties. A syndication may also be structured as an assignment, in which the issuing lender will assign its obligation to issue letters of credit to other lenders who will become counterparties to the credit facility, in direct contractual privity with the captive reinsurer. In this structure, one bank will act as an administrative agent in order to streamline reporting and payment obligations. If the issuing lender wants the ability to assign its obligations to third parties, the sponsoring insurer may want to contract for a consent right over the selection of assignees, as a way of preventing competitors from obtaining sensitive information or of managing its exposure to individual lenders.

### *Ongoing Reporting and Information Sharing*

The issuing lender will often insist on certain reporting covenants under the credit facility in order to monitor and model the performance of the ceded business. This reporting can range from the quarterly financial statements and annual reports prepared by the ceding insurer and delivered under the coinsurance agreement to more sophisticated reports or access to information.

### *Tax Considerations*

Letter of credit-based reserve financing solutions also require a careful analysis of the tax implications of each transaction in order to avoid undesired income recognition and to preserve tax deductions attributable to the subject business. A tax allocation agreement will sometimes be needed, and transactions involving an offshore captive reinsurer may raise additional complexities. In addition, given the long term nature of these arrangements (and that an original lender might assign its position to another bank) the parties must consider the possibility that -- at some point during the term of the facility -- there might be a change in law or circumstances that could result in the imposition of withholding taxes (or other taxes) on payments under the facility that were not factored into the original pricing for the transaction. The parties will typically negotiate the circumstances under which the captive reinsurer would (though a gross-up or other mechanism) bear the risk that unanticipated taxes might be imposed on payments under the facility. The parties should consult with their tax advisors prior to entering into a letter of credit-based reserve financing.

### *Regulatory Developments*

In a number of meetings and conference calls since November 2008, the Capital and Surplus Relief (EX) Working Group (the "Working Group"), which was formed by the Executive Committee of the NAIC (the "Executive Committee"), considered a nine-part capital and surplus relief proposal that was submitted to the NAIC by the American Council of Life Insurers in November 2008. The goal of the proposal was to provide life insurers with relief from certain conservative reserve requirements, including certain aspects of Regulation XXX and AG38, in time to be reflected in 2008 year-end financial statements of insurers. The Executive Committee rejected a set of recommendations on the proposal by the Working Group during a conference call on January 29, 2009, and the NAIC is now considering next steps. In light of this non-action and of current financial realities, it is likely that both short- and long-term financing solutions will continue to evolve amid the ongoing constraints in the credit markets. ■

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