DODD-FRANK ACT – IMPACT ON REINSURANCE ASSUMED BY NON-U.S. REINSURERS FROM U.S. CEDING INSURERS

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To Our Clients and Friends:

President Obama signed the Dodd-Frank Wall Street Reform and Consumer Protection Act into law on July 21, 2010. While the legislation is principally designed to address the issues arising out of the 2008 financial crisis, such as regulation and resolution of systemically significant financial companies and regulation of derivatives, there are two provisions included in the Dodd-Frank Act that may be of interest to non-U.S. reinsurers that assume risks from U.S. ceding insurers. Both of these appear in Title V. "Insurance" of the legislation. The text of the Dodd-Frank Act can be found at www.thomas.loc.gov (search for Public Law. No. 111-203).

REINSURANCE REFORM – DOMESTIC STATE DEFERENCE

Background. When a U.S. ceding insurer cedes risks to a reinsurer, it desires to obtain "credit" for that reinsurance on its financial statements filed with state insurance regulators. The majority of states impose their reinsurance credit rules on "domestic" ceding insurers, namely, those incorporated in the state. However, a number of states, including New York, impose their reinsurance credit rules on all insurers licensed in their state. In this case, for example, a Connecticut domestic ceding insurer that is licensed in New York must satisfy the reinsurance credit rules of both Connecticut and New York in order to obtain credit for the reinsurance in both states. These "extraterritorial" reinsurance credit rules can place additional burdens on the reinsurer. For example, the typical state reinsurance credit rules require that, in the case of a cession under a single reinsurance agreement with an "unauthorized reinsurer" (which includes all non-U.S. reinsurers), credit is only allowed to the extent that the reinsurer posts qualifying security for the reinsurance ceded. If the ceding insurer wants to qualify for reinsurance credit in both Connecticut and New York, it must require the reinsurer to satisfy the qualifying security rules of both Connecticut and New York. Where a single beneficiary reinsurance trust (a so-called "Regulation 114 trust") is used as the qualifying security, permitted trust assets will have to satisfy both the Connecticut and New York reinsurance credit rules. Because the New York permitted trust assets are more conservative than the Connecticut permitted trust assets, the applicable standard will be the New York permitted trust assets. Most U.S. property/casualty ceding insurers and many U.S. life ceding insurers are licensed in all states, thereby subjecting them to all U.S. extraterritorial reinsurance credit rules.

Dodd-Frank Act §531(a). U.S. federal law (the McCarran-Ferguson Insurance Regulation Act of 1945) declares that it is the intent of the U.S. Congress that the business of insurance be regulated by the states and no act of Congress may be construed to supersede any state

law for the purpose of regulating the business of insurance *unless the act specifically relates to the business of insurance*. Dodd-Frank Act §531(a) does just that. It provides that, if the ceding insurer's domestic state is accredited by the National Association of Insurance Commissioners ("NAIC") and the domestic state recognizes credit for reinsurance for the ceding insurer's ceded risk, then no other state (i.e., a non-domestic state) may deny such reinsurance credit. Since all states are currently NAIC-accredited, this preemption of non-domestic state reinsurance credit rules afforded under Dodd-Frank Act §531(a) will extend to a ceding insurer domiciled in any state. Dodd-Frank Act §531(a) is effective July 21, 2011 and will apply to all reinsurance agreements for which reinsurance credit is claimed by a U.S. ceding insurer on or after July 21, 2011, whether or not the reinsurance agreement is entered into or effective before, on or after that date.

Impact on Non-U.S. Reinsurers (Single Reinsurance Agreement Security). Beginning July 21, 2011, only New York domestic ceding insurers will have to comply with the New York reinsurance credit rules. Using the example above, starting July 21, 2011, if a Connecticut domestic ceding insurer licensed in New York is allowed reinsurance credit under the Connecticut reinsurance credit rules, it will no longer be required to comply with the New York reinsurance credit rules to be allowed reinsurance credit in New York. For that ceding insurer, the New York reinsurance credit rules will be preempted by Dodd-Frank Act §531(a). Therefore, where a single beneficiary reinsurance trust is used as the qualifying security by a non-U.S. reinsurer, the permitted trust assets will only have to satisfy the Connecticut (and not the New York) reinsurance credit rules. Hence, the more liberal Connecticut permitted trust asset requirements will apply. The same will apply to rules governing letters of credit and other permitted forms of reinsurance security. As a result, any reinsurance agreement entered into by such a Connecticut ceding insurer need only satisfy the Connecticut reinsurance credit rules on and after July 21, 2011.

Impact on Non-U.S. Reinsurers (Multiple Beneficiary Trust Security). A non-U.S. reinsurer that uses a multiple beneficiary trust as security for reinsurance ceded by U.S. ceding insurers may not benefit from the preemption effect of Dodd-Frank Act §531(a) if the trust is intended to qualify for reinsurance ceded by a U.S. ceding insurer domiciled in any state. This is because such a trust must, using our example, satisfy the Connecticut requirements for cessions by a Connecticut domestic ceding insurer but must also satisfy the New York requirements for cessions by a New York domestic ceding insurer. However, if such a trust was designed to be eligible security for reinsurance ceded by one or more ceding insurers domiciled in a single state (*e.g.*, a non-U.S. reinsurer that assumes risks only from its affiliated U.S. ceding insurers), then the trust need only satisfy the ceding insurer's domestic state reinsurance credit rules on and after July 21, 2011.

Existing Reinsurance Agreements. Dodd-Frank Act §531(a) does not modify any contractual requirements of any reinsurance agreement. Consequently, if a previously

executed reinsurance agreement expressly provides that the reinsurer must provide security that satisfies the reinsurance credit rules of both Connecticut and New York, that provision will remain effective even after July 21, 2011. However, the reinsurer could approach the U.S. ceding insurer and request an amendment to the reinsurance agreement to relieve the reinsurer of having to satisfy the New York reinsurance credit law requirements on or after July 21, 2011 (provided that Dodd-Frank Act §531(a) is then and thereafter remains in effect).

New Reinsurance Agreements Before July 21, 2011. Non-U.S reinsurers that enter into a new reinsurance agreement with a U.S. ceding insurer between now and July 21, 2011 may still be called upon to satisfy any applicable extraterritorial reinsurance credit rules since these rules remain applicable to U.S. ceding insurers until July 21, 2011. Consideration may be given to crafting these contractual provisions in such a way as to assure that, by the terms of the agreement, the imposition of the extraterritorial reinsurance credit rules on the reinsurer will sunset effective July 21, 2011 (provided that Dodd-Frank Act §531(a) is then and thereafter remains in effect).

TREATIES GIVING RISE TO PREEMPTION OF STATE LAW

Preemption Authority. Dodd-Frank Act §502 adds two provisions to U.S. federal law that provide for a mechanism for federal action to preempt state insurance laws and regulations that are inconsistent with international agreements entered into by the U.S. regarding prudential measures relating to the business of insurance and reinsurance. These provisions provide for the following:

- A new "Federal Insurance Office" ("FIO") is established in the U.S. Department of the Treasury on July 22, 2010 which will be headed by a Director appointed by the U.S. Secretary of the Treasury.

- The U.S. Secretary of the Treasury and the U.S. Trade Representative are authorized to jointly negotiate and enter into "covered agreements" on behalf of the U.S. The FIO Director is authorized to assist the U.S. Secretary of the Treasury in negotiating "covered agreements." A "covered agreement" is a written bilateral or multilateral agreement regarding prudential measures with respect to the business of insurance or reinsurance that (i) is entered into between the U.S. and one or more foreign governments, authorities or regulatory entities; and (ii) 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.

- Once a covered agreement is entered into, the FIO Director is authorized to determine whether any "State insurance measure" is preempted by the covered agreement. A "State insurance measure" is broadly defined to mean a state law, regulation, administrative ruling, bulletin, guideline, or practice relating to or affecting prudential measures applicable to insurance or reinsurance.

- A State insurance measure may be preempted by the FIO Director if the Director determines that the measure (i) results in *less favorable treatment* of a non-U.S. insurer domiciled in a foreign jurisdiction that is subject to a covered agreement than a U.S. insurer domiciled, licensed or admitted in that state, and (ii) is inconsistent with a covered agreement. Certain State insurance measures cannot be preempted such as those governing any insurer's rates, premiums, underwriting or sales practices, or state coverage requirements for insurance or the application of the antitrust laws of any state to the business of insurance.

- The FIO must give public notice of any such proposed preemption, allow comment and consider any comments and then give public notice of the effectiveness of any such preemption. States may not enforce a State insurance measure to the extent that the measure has been so preempted by the FIO Director.

Possible Application of Preemption Authority. As a result of these provisions, if the U.S. were to enter into a covered agreement with a foreign country and that agreement were to call for the limitation or elimination of reinsurance collateral requirements, then the FIO Director could commence the process to determine whether any inconsistent State insurance measure is preempted by the covered agreement.

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If you would like more information on these or other topics of interest, please contact the undersigned or any insurance industry lawyer at Debevoise & Plimpton LLP.

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