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Amendments to the NAIC Credit for Reinsurance Model Act and Model Regulation

By John Dembeck and Kevin J. Saponaro

On November 6, 2011, the National Association of Insurance Commissioners ("NAIC") adopted long-awaited amendments to its Credit for Reinsurance Model Act and Model Regulation (the "Amended Models"). As their titles indicate, these models establish the rules under which reinsurance credit is allowed a U.S. ceding insurer domiciled in the state. The key changes made in the Amended Models are:

- Adds new limits on the concentration risk a domestic ceding insurer may have in a single reinsurer, and adds a requirement that every domestic ceding insurer notify its domestic state insurance regulator if it exceeds these limits;
- Introduces a new risk-based collateral regime for unauthorized reinsurers, both U.S. and non-U.S., that includes a certification process for unauthorized reinsurers and the approval of qualified jurisdictions from which an unauthorized reinsurer may be domiciled to receive collateral reduction;
- Acknowledges the Dodd-Frank Act's preemption of extraterritorial state reinsurance credit rules that applies to nondomestic authorized insurers by deleting an optional provision on reinsurance credit allowed a foreign ceding insurer;
- Amends the contractual provisions that must be included in a reinsurance agreement in order for reinsurance credit to be allowed the ceding insurer – insolvency and reinsurance intermediary clauses; and
- Amends the multiple beneficiary reinsurance trust rules to permit a reduction in the required trusteed surplus for a single unauthorized reinsurer that has permanently discontinued underwriting new business secured by a multiple beneficiary reinsurance trust for at least three years.

This article provides an overview of the Amended Models and explains the impact they will have on the U.S. reinsurance business as states implement these key changes.

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I. Concentration Risk and Reporting

The Amended Models add a new limit on the concentration risk a domestic ceding insurer may have in a single reinsurer or a group of affiliated reinsurers, and adds a requirement that every domestic ceding insurer notify its domestic state insurance regulator within 30 days after (1) ceding to any single reinsurer, or group of affiliated reinsurers, more than 20% of the ceding insurer's gross written premium in the prior calendar year, or after it has determined that the reinsurance ceded to any single reinsurer, or group of affiliated reinsurers, is likely to exceed this limit; and (2) reinsurance recoverables from any single reinsurer, or group of affiliated reinsurers, exceed 50% of the prior year's policyholder surplus, or after it has determined that the reinsurance recoverables from any single reinsurer, or group of affiliated reinsurers, is likely to exceed this limit. These provisions are similar to the reporting requirements added by New York to its Regulation 20, effective January 1, 2011. (Model Act § 2.J)

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Equivalence Under Solvency II

By Jeremy Hill and Edite Ligere

This update summarises the main findings of the European Insurance and Occupational Pensions Authority ("EIOPA") which are set out in its advice to the EU Commission regarding the Solvency II equivalence assessment of the Bermudan, Japanese and Swiss regulatory systems published on 26 October 2011. The EU Commission is expected to make the final decision on equivalence in 2012.

What is equivalence?

Equivalence under Solvency II is a three-dimensional determination in relation to a third country's (i.e., a country outside the European Economic Area ("EEA")) regulatory regime. The three dimensions relate to: (1) equivalent treatment of reinsurance contracts with third country undertakings (i.e., equal credit for reinsurance, Article 172); (2) the ability to use local solvency calculations for the purposes of the group solvency calculations for EEA insurance groups with third-country subsidiaries (Article 227); and (3) recognition of a third country's supervisory regime for insurance groups where the parent company of the group is located in an equivalent third country (Article 260).

Why does equivalence matter?

The importance of a finding of equivalence can be significant as it allows non-EEA (re)insurance groups/EEA subsidiary entities access to equivalent treatment as far as the matters covered by Articles 172, 227 and 260 of Solvency II are concerned in EU Member States which their EEA-based competitors enjoy by virtue of their geographic location.

FINANCIAL INSTITUTIONS PARTNERS AND COUNSEL

The *Debevoise & Plimpton Financial Institutions Report* is a publication of

Debevoise & Plimpton LLP
919 Third Avenue
New York, New York 10022
+1 212 909 6000

www.debevoise.com

Washington, D.C.
+1 202 383 8000

London
+44 20 7786 9000

Paris
+33 1 40 73 12 12

Frankfurt
+49 69 2097 5000

Moscow
+7 495 956 3858

Hong Kong
+852 2160 9800

Shanghai
+86 21 5047 1800

Gregory J. Lyons
Nicholas F. Potter
Editors-in-Chief

John Dembeck
David A. Luigs
Managing Editors

Michael K. McDonnell
Sean P. Neenan
Deputy Managing Editors

All lawyers based in New York, except where noted.

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I. Reinsurance

In respect of Article 172, a finding of equivalence provides that EU Member States:

(1) must treat (re)insurance contracts concluded with undertakings with a head office in the third country in the same manner as (re)insurance contracts concluded with an undertaking which is authorised under the Solvency II Directive (Article 172 (3));

(2) cannot require pledging of assets to cover unearned premiums and outstanding claims provisions (Article 173); and

(3) shall not require the localisation within the EU of assets held to cover the technical provisions covering risks situated in the EU, nor assets representing reinsurance recoverables (Article 134).

II. Group Solvency

In respect of Article 227, there is no need to assess equivalence where group solvency of an EEA insurer with non-EEA subsidiaries is calculated under the default method under Solvency II. Under the default method of calculating group solvency, the group calculation is carried out by the EEA parent undertaking using consolidated accounts that include the related third-country insurance entities. A finding of equivalence under Article 227 is only relevant where the alternative method of calculating group solvency under Solvency II is used. In such circumstances, an EEA insurer can use the equivalent third country's local calculations for its third-country subsidiaries (as opposed to having to use Solvency II rules for solvency calculations). In short, this process involves adding the local solvency capital requirements ("SCR") and own funds (which are based on calculations made against the third country's solvency rules) to the rest of the EEA group's SCR and own funds which produces the aggregate SCR and own funds for the EEA insurance group. The importance of Article 227 to EEA insurers with third-country subsidiaries is evident from the fact that if the third country regulatory regime is not found to be equivalent, then the third-country subsidiaries will have their SCR and own funds calculated individually against Solvency II rules rather than the local rules. This may result in the imposition of stricter solvency requirements on the subsidiary than it would otherwise be subject to under local rules which could leave the subsidiary facing a competitive disadvantage against entities that are able to take advantage of the local rules.

III. Group Supervision

If there is a finding of equivalence under Article 260 for a third country's regulatory regime, then where an insurance group has operations in the EEA but its head office is in a third country, EU Member States will rely on the group supervision that is exercised by the third country, subject to a few caveats. Such caveats include that the EU Member States in conjunction with the relevant third-country supervisor could form a supervisory college led by the supervisor in the relevant third country. In the absence of an Article 260 equivalence finding, the Solvency II rules on group supervision will be applied.

Bermuda's, Japan's and Switzerland's Applications For Equivalence

The Bermuda Monetary Authority ("BMA") applied for equivalence under all three articles as did the Swiss Financial Supervisory Authority ("FINMA"). FINMA's stated objective for seeking equivalence was to streamline the process of insurance group supervision. The Japanese Financial Services Authority ("JFSA") applied for equivalence only in respect of Article 172.

> The importance of Article 227 to EEA insurers with third-country subsidiaries is evident from the fact that if the third country regulatory regime is not found to be equivalent, then the third-country subsidiaries will have their [solvency capital requirements] and own funds calculated individually against Solvency II rules rather than the local rules.

EIOPA's findings for each assessment criteria are reported under one of five categories: "equivalent,"

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"largely equivalent," "partly equivalent," "not equivalent" and "not applicable."

The following six principles underpin EIOPA's equivalence assessments. These specify that the third-country regulatory system should:

- provide a similar level of policyholder and beneficiary protection;
- maintain regulatory cooperation under conditions of professional secrecy;
- be a flexible process based upon principles and objectives;
- apply the proportionality principle;
- be applied by the third country at the time of assessment; and
- be kept under review, with equivalence advice updated at least every three years.

EIOPA's Findings on the Equivalence of the Bermudan Regulatory System With Solvency II

The Bermudan regulatory system categorises non-life insurers into four main classes (with a further sub-division of Class 3 into three sub-categories). As the BMA applies different requirements to each class, the equivalence assessment has been sub-divided accordingly.

- The Bermudan regulatory system meets the criteria for equivalence under Article 260 (group supervision for a parent company in a third country with a subsidiary in the EEA) for all classes. However, under Articles 172 and 227, only the regulatory system applicable for insurers of Classes 3A, 3B and 4 was found to be equivalent, subject to a number of caveats. In particular, EIOPA noted that in a number of cases the Bermudan provisions are still under development and, as such, the conclusions drawn will only be fully applicable once these are fully implemented.
- A number of significant weaknesses were identified in relation to the governance and disclosure requirements and around the valuation framework which is currently not risk-based for a number of classes. Also, the possibility of writing both insurance and non-insurance business in a single company represents a significant difference to the provisions under Solvency II.
- The Bermudan regime for long-term insurers has not yet been assessed, as this has only been in force since the beginning of 2011 (and the reclassification of the relevant insurers into classes has not yet been completed).
- Significant deviations between the Bermudan regulatory system and Solvency II were noted particularly surrounding governance, disclosure and the valuation framework. Consequently, equivalence was only advised for certain classes of non-life insurers, and with the additional caveat that a number of developments required for this assessment are still not fully implemented.

EIOPA's Findings on the Equivalence of the Japanese Regulatory System With Solvency II

The Japanese regulatory system was assessed for reinsurance under Article 172 only. EIOPA found that, overall, the Japanese system met the criteria for equivalence under Article 172. However, this was subject to a number of caveats. In particular, the Japanese solvency regime was found to be only "partly equivalent" for reinsurers in the level of policyholder protection it provides (although EIOPA expects this to become "largely equivalent" once the anticipated move to market consistent valuations of liabilities is finalised).

EIOPA's Findings on the Equivalence of the Swiss Regulatory System With Solvency II

The Swiss regulatory system was found to fully meet the criteria for equivalence under Article 227 for the calculation of group solvency where an EEA parent company has a subsidiary in Switzerland. Equivalence was also found under Articles 172 and 260, albeit with certain caveats.

A specific caveat in relation to the Swiss solvency regime was included under Article 172 in relation to reinsurance captives which are exempt from the Swiss Solvency Test ("SST"). These were found to be only "partly equivalent" due to the lower confidence levels applied to their solvency calculations.

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Shortcomings were also noted in relation to the governance and public disclosure requirements, particularly around the reduced level of public disclosure required and the lack of equivalent compliance and internal audit functions. FINMA are currently reviewing the governance and public disclosure requirements. EIOPA will reassess the equivalence of these areas once FINMA has concluded its review.

Other Non-EEA Jurisdictions

Other non-EEA jurisdictions, for example, Guernsey and Jersey, which are not part of the EEA (and therefore not subject to the Solvency II regime) have been considering whether to voluntarily implement measures equivalent to the Solvency II regime. At present, these jurisdictions, have no plans to seek equivalence under Solvency II. Guernsey has specifically stated that, at present, it does not intend to seek equivalence under Solvency II on the basis of encouraging growth in Guernsey's captive insurance market.

Equivalence and the U.S.

In 2010, the Committee of European Insurance and Occupational Pensions Supervisors ("CEIOPS"), EIOPA's predecessor, highlighted a number of concerns regarding the U.S. regulatory regime that would prevent the U.S. being included in the first wave of equivalence assessments, including:

- the lack of a single, central regulator for the insurance industry in the U.S.;
- the absence of any group supervisory framework for the insurance industry in the U.S.; and
- professional secrecy issues resulting in the inability of CEIOPS to exchange information with the U.S. National Association of Insurance Commissioners ("NAIC").

In a letter to CEIOPS in October 2010, the EU Commission indicated the U.S. would be a primary candidate for consideration as a "transactional regime" for equivalence. As a transitional regime, a country would receive the same benefits from equivalence as if there had been a positive equivalence finding, but this would only be for a limited amount of time.

The NAIC argued that the U.S. should be included in the first wave of equivalence assessments. It relied on the Dodd-Frank Wall Street Reform and Consumer Protection Act, passed by Congress on 21 July 2010, which established the Federal Insurance Office within the Department of the Treasury, which would facilitate stronger group supervision in support of the case for including the U.S. in the first wave of equivalence assessments.

Despite these developments, CEIOPS did not include the U.S. in the first wave of equivalence assessments. CEIOPS acknowledged the NAIC's position and deferred the decision on the U.S. to the EU Commission stating that it "stands ready to undertake an assessment of the US supervisory regime" if requested to do so.

In a letter to CEIOPS in October 2010, the EU Commission indicated the U.S. would be a primary candidate for consideration as a "transactional regime" for equivalence. As a transitional regime, a country would receive the same benefits from equivalence as if there had been a positive equivalence finding, but this would only be for a limited amount of time. By the end of the transitional period, the regime would need to fully satisfy all of the equivalence criteria in order for these benefits to be retained on a permanent basis.

The implications of not achieving equivalence are likely to vary depending on the domicile of the parent company.

Parent Domiciled in the U.S. With EEA Subsidiary

- A European subsidiary will need to calculate its stand-alone capital requirements under Solvency II.
- European supervisors have the power to require the establishment of a European insurance holding company to create a sub-group consisting of all entities domiciled in the EEA.

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A lead European supervisor would then regulate this newly created sub-group and enforce a solvency capital requirement calculation in respect of the group. There may be benefits to establishing a European holding company for multinational groups, such as, diversification benefits and the ability to work with a lead European supervisor rather than having to deal with individual EEA supervisors separately.

Certain U.S. companies have already begun to set up European holding companies preparatory to Solvency II coming into force in order to take advantage of these potential benefits.

Parent Domiciled in the EEA With U.S. Subsidiary

The U.S. subsidiary will still hold risk-based capital ("RBC") in accordance with U.S. regulations. Equivalence for the U.S. would mean that the RBC calculation could be consolidated directly into the Solvency II assessment of the aggregated group capital requirement. This would not be possible in the absence of a finding of equivalence.

Impact on U.S. Reinsurers

Non-equivalence in relation to reinsurance would mean that EEA supervisors would have the power to require U.S. companies to post collateral in relation to any reinsurance (intra-group or external) of an EEA subsidiary. This could have a significant impact on the cost of writing such business.

Conclusion

EIOPA's publication of its findings on equivalence in respect of Bermuda, Japan and Switzerland concludes a 10 month assessment and consultation process in relation to the equivalence with the Solvency II requirements of the regulatory regimes of these three jurisdictions.

> The relevance of the concept of third country equivalence with the Solvency II regime should be seen in the context of the recent: (i) postponement of the implementation date for Solvency II from 2013 to 2014; and (ii) as yet unconfirmed reports from the EU Commission regarding the possibility of another quantitative impact study following on from Quantitative Impact Study 5 before Solvency II comes into force.

EIOPA has expressly stated that it intends to assess and update its findings and advice on equivalence at least every three years, although a more regular assessment may prove necessary for jurisdictions such as Bermuda where the regulatory regime is currently under review.

The final decision on equivalence, which is due in the summer of 2012, will be made by the EU Commission. The EU Commission is not legally bound to follow EIOPA's findings on equivalence. Consequently, although in practical terms it is likely that the EU Commission will follow EIOPA's findings on equivalence, the extent to which, if any, the final decision on equivalence will be influenced by political considerations remains to be seen. Further, in terms of timing, the relevance of the concept of third country equivalence with the Solvency II regime should be seen in the context of the recent: (1) postponement of the implementation date for Solvency II from 2013 to 2014; and (2) as yet unconfirmed reports from the EU Commission regarding the possibility of another quantitative impact study following on from Quantitative Impact Study 5 before Solvency II comes into force which could further delay of the implementation of Solvency II.

Jeremy Hill is a partner and Edite Ligere is an associate in Debevoise & Plimpton LLP's London office.

jhill@debevoise.com
eligere@debevoise.com

New York Joins the "IRMA Section 711" Club

By John Dembeck

New York has enacted an amendment to its state insurance insolvency law that adds a new section that is based on Section 711 (and its related definitions) of the National Association of Insurance Commissioner's Insurer Receivership Model Act –often referred to by its acronym "IRMA". Section 711 is intended to provide financial counterparties of U.S. insurers generally the same kind of treatment afforded the rest of the financial services industry under the U.S. Bankruptcy Code (for U.S. entities other than banks and insurers) and the Federal Deposit Insurance Act (for U.S. banks) (the "FDIA"). U.S. insurers, being regulated by the states and subject to receivership under state law, are not subject to these federal laws.

This legislation makes New York the 18th state to enact this kind of legislation for U.S. insurers. The other states that have so far enacted similar legislation are Connecticut (1998), Michigan (2004), Iowa (2005), Maryland (2005), Texas (2005), Utah (2007), Illinois (2010), Massachusetts (2010), Minnesota (2010), Missouri (2010), Arizona (2011), Delaware (2011), Indiana (2011), Maine (2011), Nebraska (2011), Ohio (2011) and Virginia (2011).

Summary of Legislation

This New York legislation adds a new Section 7437 to Article 74 of the New York Insurance Law – the New York insurance insolvency law. Section 7437 provides for the following:

Section 7437(a). This section defines key terms including "qualified financial contract" ("QFC"), "netting agreement" and "security arrangement." A QFC is defined substantively the same as in the FDIA and includes a commodity contract, forward contract, repurchase agreement, securities contract and a swap agreement, each as defined using or referring to the applicable FDIA definition.

Section 7437(b)(1). This section provides that a person may not be stayed or otherwise prohibited from exercising (1) a contractual right to cause the termination, liquidation, acceleration or close out any netting agreement or QFC with an insurer because of (a) the insolvency, financial condition, or default of the insurer, provided that the right is enforceable, or (b) the commencement of receivership proceeding, (2) a right under a security arrangement relating to one or more netting agreements or QFCs, or (3) subject to existing statutory exceptions to the right to setoff in Section 7427, a right to setoff or net out a termination value, payment amount, or other transfer obligation arising under or in connection with one or more QFCs under specified circumstances. Section 7437(b)(2) includes a special rule on measuring damages if a counterparty liquidates, closes out or accelerates the agreement or contract.

Section 7437(c). This section provides that, on termination of a netting agreement or QFC, the net or settlement amount owed by a nondefaulting party to an insurer against which a receivership application has been filed must be transferred to or on the order of the receiver for the insurer, even if the insurer is the defaulting party or the agreement or contract includes a "walkway clause." A limited two-way or first method payment provision in a netting agreement or QFC with an insurer that has defaulted is deemed to be a full two-way payment or second method provision against the insurer. Any such net or settlement amount is an asset of the insurer, except to the extent the amount is subject to a secondary lien or encumbrance or rights of netting or setoff.

Section 7437(d). This section specifies the permitted kinds of transfers that a receiver of an insurer subject to a receivership proceeding may make if it transfers a netting agreement or QFC. It prohibits "cherry-picking" by the receiver – the receiver may either transfer all the agreements or contracts between the insurer and the counterparty (or any of the counterparty's affiliates) or none of such agreements or contracts.

Section 7437(e). This section specifies the receiver's duties in notifying a party to the netting agreement or QFC of any transfer.

Section 7437(f). Subject to limited exceptions, Section 7437(f) provides that a receiver for an insurer may not avoid a transfer of money or other property (i.e., "clawback") arising under or in connection with a netting agreement or QFC or any security

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arrangement relating to a netting agreement or QFC that is made before a receivership proceeding commences.

> Section 711 is intended to provide financial counterparties of U.S. insurers generally the same kind of treatment afforded the rest of the financial services industry under the U.S. Bankruptcy Code (for U.S. entities other than banks and insurers) and the Federal Deposit Insurance Act (for U.S. banks).

Section 7437(g). This section specifies the permitted kinds of actions that a receiver of an insurer subject to a receivership proceeding may make if it disaffirms or repudiates any netting agreement or QFC. Like the transfer limitations in Section 7437(d), it prohibits "cherry-picking" by the receiver – the receiver may either disaffirm or repudiate all the agreements or contracts between the insurer and the counterparty (or any of the counterparty's affiliates) or none of such agreements or contracts. Section 7437(g) also includes special rules on timing of a counterparty claim arising from disaffirmance or repudiation measuring damages for such a claim.

Section 7437(h). This section provides that all rights of a counterparty under Article 74 will apply to a netting agreement and a QFC entered into on behalf of, or allocated to, (1) the general account of the insurer, or (2) a separate account of the insurer if the assets of the separate account are available only to a counterparty to a netting agreement and a QFC entered into on behalf of, or allocated to, that separate account.

New York Differences from IRMA 711

There are two main differences between Section 7437 as enacted in New York and IRMA Section 711. These are:

Affiliate Transactions Included. Section 7437 applies to persons who are affiliates of an insurer that is the subject of the receivership proceeding whereas IRMA Section 711 does not. This means that an insurance group could have one of its members (a conduit) face the market for all QFCs for other group members and the conduit enter into back-to-back transactions with its affiliates, including an affiliated New York domestic insurer, without losing the benefits of Section 7437. Of course, transactions between the New York domestic insurer and the conduit would be subject to existing regulatory standards for transactions between the insurer and its affiliates and, if the transaction between the insurer and the conduit were material, they would be subject to filing with and approval or nondisapproval by the New York Department of Financial Services.

Financial Guaranty Insurers Excepted. Section 7437 does not apply to "an insurer licensed to write financial guaranty insurance." Since, under New York law, only a monoline financial guaranty insurance corporation is permitted to write financial guaranty insurance, Section 7437 will not apply to a financial guaranty insurance corporation.

Effective Date

Section 7437 became effective December 12, 2011 but it applies only to a New York insurer receivership proceeding that commenced on or after that date. Section 7437 will not apply to any New York insurer receivership proceeding pending on that date.

John Dembeck is counsel in Debevoise & Plimpton LLP's New York office.

jdembeck@debevoise.com

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II. Risk-Based Collateral Regime

The centerpiece of the Amended Models, and the reason why they were amended in the first place, is the addition of a new risk-based collateral regime which (1) permits a state insurance regulator to certify an unauthorized reinsurer, both U.S. and non-U.S., as a reinsurer in the state and determines "qualifying jurisdictions" in which an unauthorized reinsurer must be domiciled in order to be eligible for certification; and (2) implements a sliding scale of collateral posting requirements for a certified reinsurer in lieu of the longstanding 100% collateral requirements imposed on reinsurance ceded to unauthorized reinsurers. Certification as a reinsurer will apply to both an unauthorized reinsurer that posts collateral for reinsurance ceded to a single ceding insurer using permitted security vehicles (funds withheld, letter of credit and assets deposited in a single beneficiary reinsurance trust) and an unauthorized reinsurer that posts collateral ceded to all U.S. ceding insurers using a multiple beneficiary reinsurance trust.

A. Certification of Unauthorized Reinsurers

To be eligible for certification as a reinsurer by a state insurance regulator, the Amended Models require the unauthorized reinsurer to: (1) be domiciled and licensed to transact insurance or reinsurance in a "qualified jurisdiction;" (2) maintain minimum capital and surplus in an amount determined by the state insurance regulator by regulation ($250 million in Model Regulation § 8.B(3)(b)); (3) maintain acceptable financial strength ratings from two or more rating agencies; (4) submit to the jurisdiction of the certifying state and provide security for 100% of its liabilities attributable to U.S. ceded reinsurance if it resists enforcement of a final U.S. judgment; (5) agree to information filing requirements for the initial certification and on an ongoing basis, including annual reporting of assumed reinsurance, certification from the reinsurer's domestic regulator that the reinsurer is in good standing, and notification within 10 days of any regulatory action against, change in domiciliary license for or change in rating of the reinsurer; and (6) satisfy any other requirements the state insurance regulator deems relevant. (Model Act § 2.B; Model Regulation § 8.B)

If an applicant for certification is already a certified reinsurer in an NAIC-accredited jurisdiction, the state insurance regulator reviewing the application may defer to the certification and rating assigned by that jurisdiction, and the applicant will be considered a certified reinsurer in the state for which it is applying. (Model Law § 2.E(6))

B. Rating of Certified Reinsurer

The Model Regulation provides detailed criteria and instructions for the rating of certified reinsurers. Some factors that a state insurance regulator may consider in determining a reinsurer's rating include the business practices of the reinsurer in dealing with its ceding insurers; the reputation of the certified reinsurer for prompt payment of claims under reinsurance agreements; and the report of an independent auditor on the financial statements of the insurance enterprise. For U.S.-domiciled reinsurers, the state insurance regulator may review the most recent applicable NAIC annual statement blank Schedule F (for property/casualty reinsurers) or Schedule S (for life and health reinsurers), while reinsurers domiciled outside the U.S. may file for review a new annual Form CR-F (for property/casualty reinsurers) or Form CR-S (for life and health reinsurers), which are attached as exhibits to the Model Regulation. The certified reinsurer ratings are divided into six categories along a sliding scale of required collateral posting, ranging from 0% required security for the most secure to 100% required security for reinsurers rated as vulnerable. (Model Regulation § 8.A)

The state insurance regulator may revise a certified reinsurer's ratings as circumstances change. The rating may be lowered in the event of a rating agency downgrade or other disqualifying circumstance, in which case the collateral requirements for the new rating apply to all the business the reinsurer has assumed as a certified reinsurer. The state insurance regulator may also upgrade a rating in which case the certified reinsurer may post security applicable to its new rating on a prospective basis; however, the certified reinsurer must continue to post security under the previously applicable collateral requirements as to all reinsurance in force on or before the effective date of the upgrade. (Model Regulation § 8.B(8))

C. Written Notice and Public Posting

Upon receipt of an application for certification, the state insurance regulator must post notice on the insurance department's website to allow for public comment for at least

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30 days before taking final action on the application. (Model Regulation § 8.B(1)) The state insurance regulator must also provide written notice to the certified reinsurer upon approval that includes the certified reinsurer's rating, and maintain a public list of all certified reinsurers and their ratings. (Model Regulation § 8.B(2))

D. Qualified Jurisdictions

The Amended Models establish criteria for a state insurance regulator to create and publish a list of "qualified jurisdictions" from which a licensed and domiciled reinsurer may be eligible for certification as a certified reinsurer.

In the case of a non-U.S. jurisdiction, the state insurance regulator must evaluate the jurisdiction in several respects, including the extent of reciprocal recognition the jurisdiction affords U.S.-domiciled reinsurers, the form and substance of financial reports required to be filed and operating standards for reinsurers in the jurisdiction, and any documented evidence of substantial problems with the enforcement of final U.S. judgments in the jurisdiction.

U.S. jurisdictions that meet the NAIC accreditation standards, which includes all 50 states at present, are recognized as qualified jurisdictions.

If a state insurance regulator approves a jurisdiction as qualified that does not appear on the NAIC's list of qualified jurisdictions, the regulator must provide "thoroughly documented justification" for the approval consistent with the criteria in the Model Regulation. (Model Regulation § 8.C)

E. Effective Date Rule

The new risk-based collateral regime has the following effective date rule:

> Credit for reinsurance under this section shall apply only to reinsurance contracts entered into or renewed on or after the effective date of the certification of the assuming insurer. Any reinsurance contract entered into prior to the effective date of the certification of the assuming insurer that is subsequently amended after the effective date of the certification of the assuming insurer, or a new reinsurance contract, covering any risk for which collateral was provided previously, shall only be subject to this section with respect to losses incurred and reserves reported from and after the effective date of the amendment or new contract. (Model Regulation § 8.A(5))

F. Collateral Reduction is Not Mandated

Even if an unauthorized reinsurer becomes a certified reinsurer and risks ceded to it by a U.S. ceding insurer are allowed reinsurance credit based on a reduced security requirement, the Model Regulation makes it clear that the parties to a reinsurance agreement may agree to provisions establishing security requirements that exceed the minimum security requirements established for certified reinsurers. (Model Regulation § 8.A(6)) Therefore, even if an unauthorized reinsurer becomes a certified reinsurer in the domestic state of a U.S. ceding insurer, the parties can provide in the reinsurance agreement for more than the minimum required security to be posted by the certified reinsurer.

III. Dodd-Frank Preemption

The prior version of the Model Act had an optional section pertaining to credit allowed a foreign ceding insurer, and permitted an enacting state to impose its reinsurance credit rules on foreign ceding insurers licensed in that state. Several states, including New York, imposed their credit for reinsurance rules extraterritorially in this manner prior to the passage of the Dodd-Frank Act. Section 531(a) of the Dodd-Frank Act took effect on July 21, 2011 and expressly preempts the extraterritorial application of a state's reinsurance credit rules. In acknowledgment of this preemption, the Amended Model Act deletes the section on credit allowed a foreign ceding insurer, as credit for reinsurance is now governed solely by the laws and regulations of the domestic state of the ceding insurer.

IV. Contractual Provisions Required for Reinsurance Credit

The section of the Model Regulation setting forth contractual provisions that must be included in a reinsurance agreement in order for reinsurance credit to be allowed the ceding insurer has been amended. The required "proper insolvency clause" now must expressly stipulate that reinsurance is payable directly to the liquidator or successor without diminution regardless of the status of the ceding insurer. Additionally, reinsurance contracts must now include a proper

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reinsurance intermediary clause, if applicable, stipulating that the credit risk for the intermediary is carried by the reinsurer. The Model Regulation previously recommended, but did not require, a reinsurance intermediary clause. (Model Regulation § 14)

Prior to developing the Amended Models, the NAIC concluded that the new risk-based collateral regime would not be required for NAIC accreditation, therefore, states may elect to retain the existing 100% collateral security requirements for reinsurance ceded to unauthorized reinsurers without running the risk of loss of NAIC accreditation.

V. Reduction of Trusteed Surplus

The Model Act permits credit for reinsurance when a single unauthorized reinsurer maintains a trust fund in a qualified U.S. financial institution for the payment of valid claims by all of its U.S. ceding insurers, i.e., a multiple beneficiary trust. The reinsurer must maintain a trusteed surplus of not less than $20 million. However, the Amended Models now permit a reduction in the required trusteed surplus for such a reinsurer that has permanently discontinued underwriting new business secured by the trust for at least three years. (Model Act § 2.D(3); Model Regulation § 7.B(2)) The reduction may be authorized by the state insurance regulator with principal regulatory oversight of the trust. Furthermore, the new minimum required trusteed surplus may not be reduced to an amount less than 30% of the reinsurer's liabilities attributable to reinsurance ceded by the U.S. ceding insurers covered by the trust.

NAIC Review in Two Years

The NAIC, in a preface to the Amended Models, states that it will reexamine the collateral amounts in the Amended Models within two years – in November 2013.

NAIC Accreditation

NAIC model laws and regulations are merely recommended laws and regulations relating to the regulation of insurance in the U.S. that become effective only when enacted into law or promulgated as a regulation in a state. Some models have been enacted in very few states and some models have been enacted in all states in some form or another. The NAIC developed a program to accredit U.S. state insurance regulators in 1990. Part A of the accreditation standards consists of confirming that a state has laws and regulations in place to address 18 key areas, one of which is credit for reinsurance. A state can satisfy this requirement by having a state law containing the Model Act or a substantially similar law and the Model Regulation.

While the changes to the Amended Models represent a recommendation by the NAIC, the NAIC may consider whether to make these changes a condition to satisfying the credit for reinsurance accreditation standard. This is a process that has many steps. If a decision is made to make all or part of these changes an accreditation standard, the changes will not, in the usual course, become an accreditation standard for at least 4 years from the beginning of the process. However, if all or part of these changes become an accreditation standard, that will serve as a strong inducement to each state to enact or promulgate the changes by the end of the 4-year process. Prior to developing the Amended Models, the NAIC concluded that the new risk-based collateral regime would not be required for NAIC accreditation, therefore, states may elect to retain the existing 100% collateral security requirements for reinsurance ceded to unauthorized reinsurers without running the risk of loss of NAIC accreditation.

John Dembeck is counsel and Kevin J. Saponaro is an associate in Debevoise & Plimpton LLP's New York office.

jdembeck@debevoise.com
kjsaponaro@debevoise.com