Reinsurance Overview

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Objectives

- Discuss reinsurance and its importance in the context of financial solvency regulation
- Provide a basic overview of how reinsurance is regulated in the U.S.
- Review reinsurance-related statutory accounting, reporting and risk transfer requirements
- Review common issues with respect to the analysis of reinsurance programs and agreements
- Discuss recent developments and current issues in U.S. reinsurance regulation

Reinsurance

- Reinsurance allows for maximization of the principle of insurance, i.e., the spreading of risk
- In simplest terms, it is insurance for insurance companies
- Essentially, it is a contractual promise from one insurer to indemnify another insurer, which in many cases may not be presented for collection until long after the contractual obligations are created

Primary Purposes

- <u>Capacity</u> – allows ceding insurer to increase its capacity to write more insurance
- <u>Catastrophe protection</u> – protects ceding insurer from excessive losses due to catastrophic events
- <u>Stabilization</u> – provides more stable underwriting results for ceding insurer by avoiding widely fluctuating experience
- <u>Financing</u> – helps offset statutory accounting surplus strain from writing an increasing amount of new business

Importance to Financial Solvency Regulation

- Reinsurance transactions significantly affect reported financial results, financial ratios and Risk Based Capital (RBC)

- Under statutory accounting requirements, accounting and reporting differs significantly depending on whether agreement is prospective or retroactive in nature, and whether there is an adequate transfer of insurance risk; <u>transparency of reinsurance transactions is critical</u>

- Ceding insurer maintains its obligation to primary policyholder regardless of whether reinsurer fulfills its obligation to indemnify the ceding insurer

Importance to Financial Solvency Regulation

- Reinsurance frequently has been a key factor in troubled company situations
- Contracts can be complex, subject to misinterpretation between contracting parties
- Successful insurance company management generally requires high degree of reinsurance understanding
- Comprehensive analysis of a reinsurance program requires a thorough understanding of the rights and obligations of each party under the agreements

U.S. Reinsurance Regulation

- U.S. system takes a direct as well as an indirect approach to reinsurance regulation
- Direct – U.S. domiciled assuming insurers
  - Subject to the same level of oversight, disclosure and solvency requirements as U.S. primary insurers
- Indirect – use of reinsurance by U.S. ceding insurers
  - Credit for Reinsurance Model Law is the cornerstone of reinsurance regulation in the U.S.
  - Regulation of financial statement credit for reinsurance focuses on solvency of the ceding insurer and the impact of reinsurance on the ceding insurer's financial condition, and ultimately the financial impact on consumers of insurance products

U.S. Reinsurance Regulation

- Authorized Reinsurer:
  - Licensed in the same state of domicile as the ceding company;
  - Accredited by the domiciliary insurance department of the ceding company;
  - Domiciled and licensed in a state with substantially similar credit for reinsurance laws as the ceding company's domicile; or
  - Maintains a multi-beneficiary trust in the U.S.
- If the reinsurer is not authorized, or is not approved, the reinsurance is "unauthorized"
- Under the NAIC model law, a U.S. ceding company must hold collateral in order to take financial statement credit for reinsurance ceded to an unauthorized reinsurer
- Significant reforms are in process that will change this requirement under certain conditions

Risk Transfer

- Insurance risk transfer is the essential ingredient of a reinsurance contract

- Insurance risk includes both:
  - Underwriting risk – uncertainties about the ultimate amount of net cash flows from premiums, commissions, claims and claim settlement expenses

  - Timing risk – the timing of the receipt and payment of those cash flows

- Various analytical methods are utilized to evaluate contracts for risk transfer

Risk Transfer

- Statutory financial statements include several disclosures to facilitate the identification of specific characteristics in reinsurance contracts that warrant further analysis as to whether risk transfer is sufficient
- There is no “bright-line” test in statutory accounting; requires case-by-case analysis
- CEO and CFO of the reporting company must specifically attest that reinsurance contracts are accounted for appropriately in the statutory financial statements

Statutory Accounting & Reporting

- Reinsurance Accounting (net of reinsurance basis)
  - Agreement is prospective in nature (i.e., covers future events)
  - Agreement transfers an adequate amount of underwriting <u>and</u> timing risk to the reinsurer
  - Recoverable on paid losses recorded as an asset, reserves are reduced by reinsurance ceded; impact of transaction flows through underwriting results

- Retroactive Accounting
  - Agreement is retroactive in nature (i.e., covers past events)
  - Agreement transfers a significant amount of underwriting <u>and</u> timing risk to the reinsurer
  - More restrictive than prospective accounting treatment; paid losses and reserves are reported gross of reinsurance; surplus restricted

Statutory Accounting & Reporting

- Deposit Accounting
  - To the extent that a reinsurance agreement does not, despite its form, transfer both components of insurance risk, all or part of the agreement is accounted for and reported as a deposit
  - Applies whether the agreement is prospective or retroactive
  - All cash flows are processed through a deposit account
  - No reduction in reserves or liabilities
  - Any gain from the transaction is not recognized until termination

Reinsurance Reporting

- Various annual/quarterly statement underwriting exhibits provide information with respect to the impact of reinsurance transactions on premium, losses and expenses
- Reinsurance schedules (“F” for Property/Casualty, “S” for Life, Accident & Health) disclose significant details about reinsurance transactions and balances by counterparty, and restate the Balance Sheet to a gross of reinsurance basis to identify the net credit for reinsurance in the financial statements
- Specific reinsurance disclosures provide details on reinsurance program and specific types of transactions

Reinsurance Analysis

- Adequate reinsurance cover
  - Does the company have an appropriate reinsurance program with adequate/appropriate reinsurance cover in place?
- Quality / financial strength of reinsurers
  - Does the company appropriately manage its credit risk from reinsurance through using quality reinsurance, monitoring the condition of reinsurers?
  - Does the company obtain collateral when required or when appropriate; and is the reinsurance reliable?
- Affiliated reinsurance arrangements
  - Is there any unusual shifting of risk among affiliates?
- Diversification
  - It may be prudent for the ceding company to use a sufficient number of reinsurers to further distribute financial risk.

Reinsurance Analysis

- Proper transparency / disclosure in the financial statements
  - Do the financial statements accurately reflect the reinsurance that is in place?
  - Do any contracts exist with characteristics that dictate the need for more detailed risk transfer analysis?
  - Are the amounts reported as recoverables likely to be collected?
  - Are the contracts legitimate reinsurance agreements?
  - Particular attention to commutations and Loss Portfolio Transfers

Reinsurance Analysis

- Fronting
  - Any abuses of this practice?
  - Quality of reinsurers behind any fronting programs?
- Reinsurance Intermediaries
  - Any unusual arrangements?
- Assumed reinsurance
  - Does the company have the appropriate expertise to analyze, underwrite, monitor and service the assumed business?

U.S. Reinsurance Collateral Debate

- Over the past decade, non-U.S. reinsurers and regulators have called for the elimination of collateral requirements for financially strong reinsurers domiciled in well-regulated jurisdictions
- U.S. regulators have acknowledged the need to modernize reinsurance regulation
- International efforts continue toward facilitating the development of an effective and efficient global reinsurance supervisory framework based on mutual recognition of reinsurance supervision

NAIC Reinsurance Regulatory Modernization Framework

- First step in an effort to facilitate cross border reinsurance transactions and enhance competition in the U.S. market while ensuring that U.S. insurers and policyholders are adequately protected against the risk of insolvency
- Based on the principles of single-state supervision for U.S. and non-U.S. insurers' U.S. reinsurance business; recognition of reinsurance supervision; and collateral reduction based on financial strength and business practices
- Adopted by NAIC in December 2008; NAIC proposed federal legislation to implement, but not enacted

Federal Dodd-Frank Act

- Federal legislation signed into law on July 21, 2010
- Broad U.S. financial regulatory reform
- Does not include the NAIC's proposed federal reinsurance legislation
- Does include provisions that impact reinsurance
  - Nonadmitted and Reinsurance Reform Act (NRRA)
  - Federal Insurance Office Act

Nonadmitted and Reinsurance Reform Act

- Becomes effective on July 21, 2011
- Prohibits a state from denying credit for reinsurance if the domiciliary state of the ceding insurer recognizes such credit and is an NAIC-accredited state
- Reserves to a reinsurer's domestic state the sole responsibility for regulating the reinsurer's financial solvency, so long as it is an NAIC-accredited state
- Facilitates state-based approach to implementation of NAIC reinsurance reforms

Federal Insurance Office

- Under U.S. Department of the Treasury
- FIO is not a regulator or supervisor, but has authority to:
  - Receive information on the insurance sector
  - Enter into binding “covered agreements” with international bodies
  - Preempt a state insurance measure under certain conditions
- FIO may preempt a state insurance measure to the extent that it:
  - 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, admitted or otherwise authorized in that state; and
  - is inconsistent with such covered agreement

State and NAIC Reforms

- In light of these developments, individual states began to express interest in reforming state laws to reduce collateral requirements for eligible reinsurers
  - Florida (2007/2008)
  - New York (2010)
  - New Jersey and Indiana (2011)
  - Other states currently considering similar proposals
- NAIC is working to incorporate key elements of the adopted Reinsurance Framework into the *Credit for Reinsurance Model Law* and *Regulation* to facilitate uniformity in state-based reinsurance reforms

NAIC Model Law Revisions

- Certification process for reinsurers – a certified reinsurer will be eligible for collateral reduction with respect to contracts entered into or renewed subsequent to certification

- Each state has authority to certify reinsurers, or may recognize the certification granted by another NAIC-accredited state

- A state will evaluate a reinsurer that applies for certification, and will assign a rating based on the evaluation; a certified reinsurer will be required to post collateral in an amount that corresponds with its assigned rating in order for a U.S. ceding insurer to be allowed full credit for reinsurance ceded

NAIC Model Law Revisions

- States will evaluate the reinsurance supervisory regime of a non-U.S. jurisdiction in order to determine if it is a "qualified jurisdiction"
- States may also defer to an NAIC list of recommended qualified jurisdictions
- The commissioner will create and publish a list of jurisdictions whose reinsurers may be approved by the commissioner as eligible assuming insurers
- Qualified jurisdiction must agree to share information and cooperate with the commissioner with respect to all certified reinsurers doing business within the jurisdiction

Next Steps

- Final drafts to be considered for adoption by the Reinsurance Task Force during the NAIC 2011 Summer National Meeting
- NAIC Plenary to consider final drafts for adoption by year-end 2011
- Consider corresponding changes to NAIC Accreditation Standards and other implementation issues
- Continue efforts to coordinate with FIO
- Monitor progress on RTF website: http://www.naic.org/committees_e_reinsurance.htm

Questions?