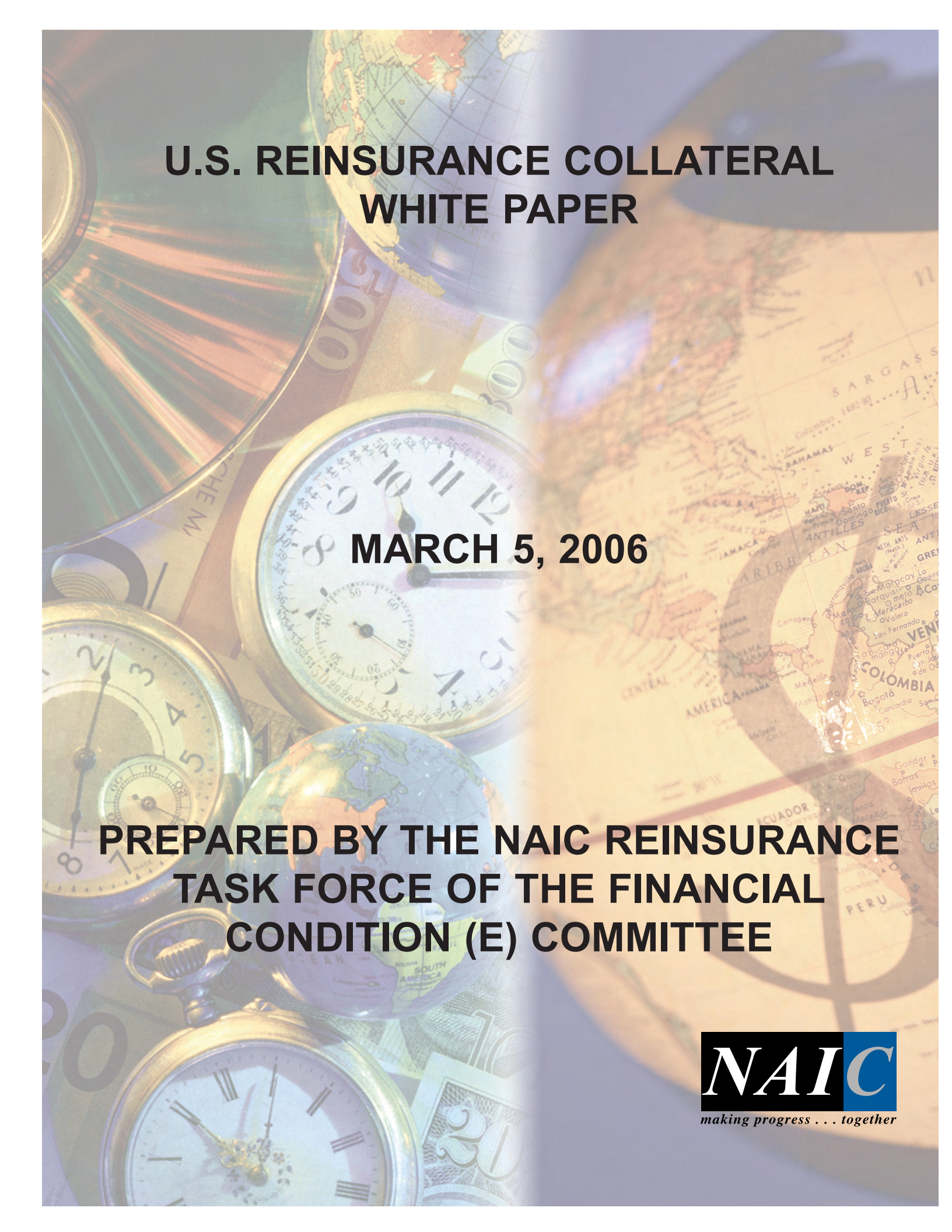




U.S. REINSURANCE COLLATERAL WHITE PAPER

MARCH 5, 2006

**PREPARED BY THE NAIC REINSURANCE
TASK FORCE OF THE FINANCIAL
CONDITION (E) COMMITTEE**

U.S. Reinsurance Collateral White Paper

March 5, 2006



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of Insurance Commissioners**

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**PREPARED BY THE NAIC REINSURANCE TASK FORCE
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EXECUTIVE SUMMARY

Purpose of Paper

With regard to reinsurance, the U.S. system takes both a direct and indirect approach. The direct regulation relates to the solvency supervision of U.S. based reinsurance companies themselves. As with primary companies, the domestic regulator is responsible for performing periodic financial examinations and for the ongoing solvency supervision of U.S. based reinsurance companies. The indirect regulation of reinsurance relates to how U.S. primary companies are given statutory credit on their balance sheet for business they transfer via reinsurance. This system of credit for reinsurance has allowed U.S. regulators to avoid the need to assess the wide variety of regulatory systems in the reinsurers' home countries and reconcile their accounting and oversight frameworks to their U.S. equivalents. Since there are a variety of systems of regulation and accounting around the world, the differences between them and the U.S. are less material due to the requirement that the reinsurance obligations of unauthorized reinsurers must be 100% collateralized in order for the ceding company to take balance sheet and income statement credit. U.S. regulators have imposed over the last decade on Non-U.S. based reinsurers with trust funds in the U.S, a significant level of direct regulation including: (a) filing quarterly reports of detailed financials to evidence adequacy of the MBT, (b) providing details of retrocessions and (c) filing audited annual reports where the reinsurance reserves have been certified by a qualified actuary. This has enabled U.S. regulators to exercise direct supervision and to develop a good understanding of these reinsurers and their regimes.

Representatives of non-U.S. based unauthorized reinsurers are seeking to amend the credit for reinsurance laws and to introduce a regulatory regime that distinguishes financially strong reinsurers from weak reinsurers, irrespective of their state or country of domicile, and for collateral to be determined as appropriate. This position has been supported by representatives of unauthorized reinsurers, foreign regulators and other government representatives who have also provided documentary evidence to regulators to help progress the debate.

The purpose of this white paper is to provide, at the request of the NAIC's Reinsurance Task Force, a balanced synopsis of the historical arguments in favor of and against amending U.S. reinsurance collateral requirements. This report was written to provide the task force with a basis, in whole or in part, to make public policy recommendations intended to address future developments concerning this issue. The study is based on a review of historical data collected and compiled by various interested parties as well as the NAIC financial reporting database. The goal of ongoing discussions concerning this issue is to learn about various stakeholders' perspectives.

Background

All states currently require unauthorized reinsurers utilizing a multibeneficiary trust to post 100% collateral against reinsurance obligations underwritten in the United States whether those insurers are based in the U.S. or elsewhere. U.S. ceding insurers, in order to gain credit in their financial statements for their cessions to unauthorized reinsurers, must have collateral backing those liabilities. However, U.S. ceding insurers have the option to cede to unauthorized companies and not take posted collateral resulting in a direct reduction in surplus for any uncollateralized liabilities. This 100% gross liabilities

requirement has been in place for many years owing to regulatory concerns for marketplace solvency and consumer protections. The unauthorized reinsurance liabilities that must be collateralized include:

1. Paid losses
2. Paid loss adjustment expenses (LAE)
3. Unearned premium reserves
4. Known case loss and LAE reserves
5. Incurred but not reported (IBNR) loss and LAE reserves
6. Contingent commissions¹

Hereafter, the recovery of the above mentioned liabilities would be referred to as reinsurance recoverables.

Reinsurance capital moves quickly worldwide in search of attractive returns. In the wake of major catastrophes (e.g. Hurricane Andrew, Terrorist Attacks of September 11, 2001, Hurricane Katrina, etc.) billions of dollars in capital and new reinsurers based their operations in jurisdictions outside of the U.S. This document will attempt to provide a basic understanding of the international business of reinsurance, the reasons that companies purchase reinsurance and provide a perspective for arguments in favor of reducing and also in favor of maintaining current U.S. reinsurance collateral requirements.

It should be noted that specific terminology will be discussed in the paper concerning “authorized” and “unauthorized” reinsurance. In the U.S., an “authorized” reinsurer is one that is either licensed in the ceding insurer’s state of domicile to write the same type of business, an accredited reinsurer in the ceding insurer’s state of domicile, or is given regulatory equivalence by being licensed in a state with substantially similar credit for reinsurance laws and regulations through various specified means. An ‘unauthorized’ reinsurer does not simply mean ‘non-U.S.’. A U.S. domiciled reinsurer that does not meet the above criteria is also considered ‘unauthorized’ for credit for reinsurance purposes in states where such a reinsurer is not licensed or granted equivalence. However, non-U.S. reinsurers cannot become accredited in a U.S. state, based upon their own domestic license. They must establish a licensed insurance operation in the U.S., for the rules described above to apply equally. In other words, every authorized reinsurer must be a U.S. licensed entity, but not every unauthorized reinsurer is based outside of the U.S., although many of them are.

The importance of reinsurance recoverables to the U.S. insurance marketplace and the U.S. insurance-buying public cannot be over-emphasized. Statistics show that reinsurance recoverables on paid and unpaid property/casualty losses when excluding pooling arrangements were nearly U.S. \$332 billion² as of December 31, 2004, and collateral from unauthorized reinsurers (primarily non-U.S. reinsurers) amounted to \$127.4 billion or 38.3%³ of the total recoverables. The \$332 billion represents 65.9⁴ percent of the surplus of U.S. property/casualty insurers.⁵ As depicted in the graphs (Figures 1 and 2), the

¹ For definitions of key terms, please see Glossary in Appendix III.

² \$332B figure has not been consolidated to eliminate inter-company transactions; consolidated industry total is \$240B.

³ This percentage is 46.1% when calculated using consolidated industry totals.

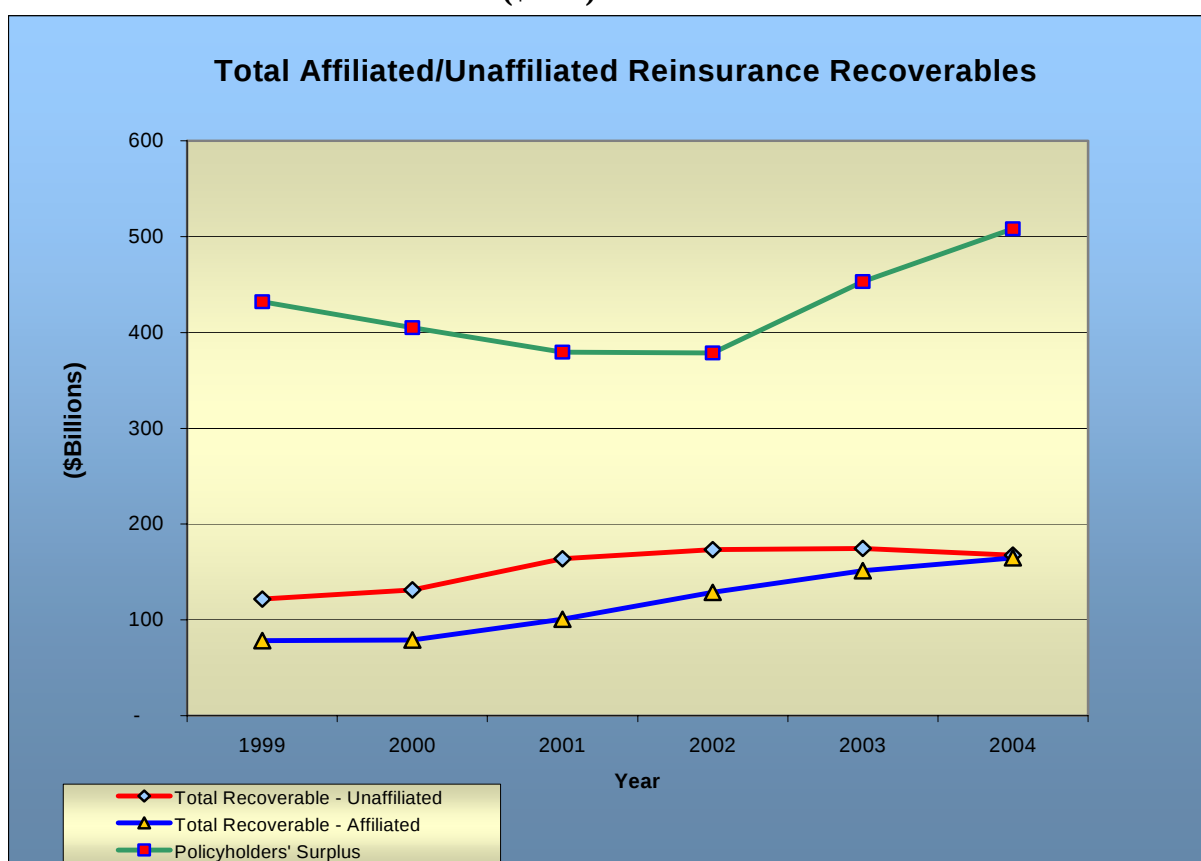
⁴ This percentage is 59.3% when calculated using consolidated industry totals.

⁵ NAIC Financial Repository Database 2004: According to the NAIC Annual Statement Instructions for Property/Casualty insurers, property/casualty lines of business, include: fire, allied, farm owners multiple-peril, homeowners multiple-peril, commercial multiple-peril, mortgage guaranty, ocean marine, inland marine, financial guaranty, medical malpractice, earthquake, group accident and health, credit accident and health (group and individual), other accident and health, workers’

percentage of reinsurance recoverables to surplus represents a significant amount, which is precisely why this issue has taken on increased importance for all parties involved. U.S. affiliated reinsurance recoverables have been growing by an average compounded annual rate⁶ of 16.0% from 1999-2004 while unaffiliated transactions have only increased 6.4%. Unauthorized reinsurance recoverables have grown at a 16.6% annual rate while authorized balances have increase at an annual pace of 8.7% over the same time horizon. By comparison, the overall industry surplus has increased 3.3% annually from 1999-2004 to \$508.3B⁷.

Figure 1 - Property/Casualty Reinsurance Affiliated and Unaffiliated Recoverables (Excluding Pools) Compared to Policyholder Surplus

(\$U.S.)



Source: National Association of Insurance Commissioners

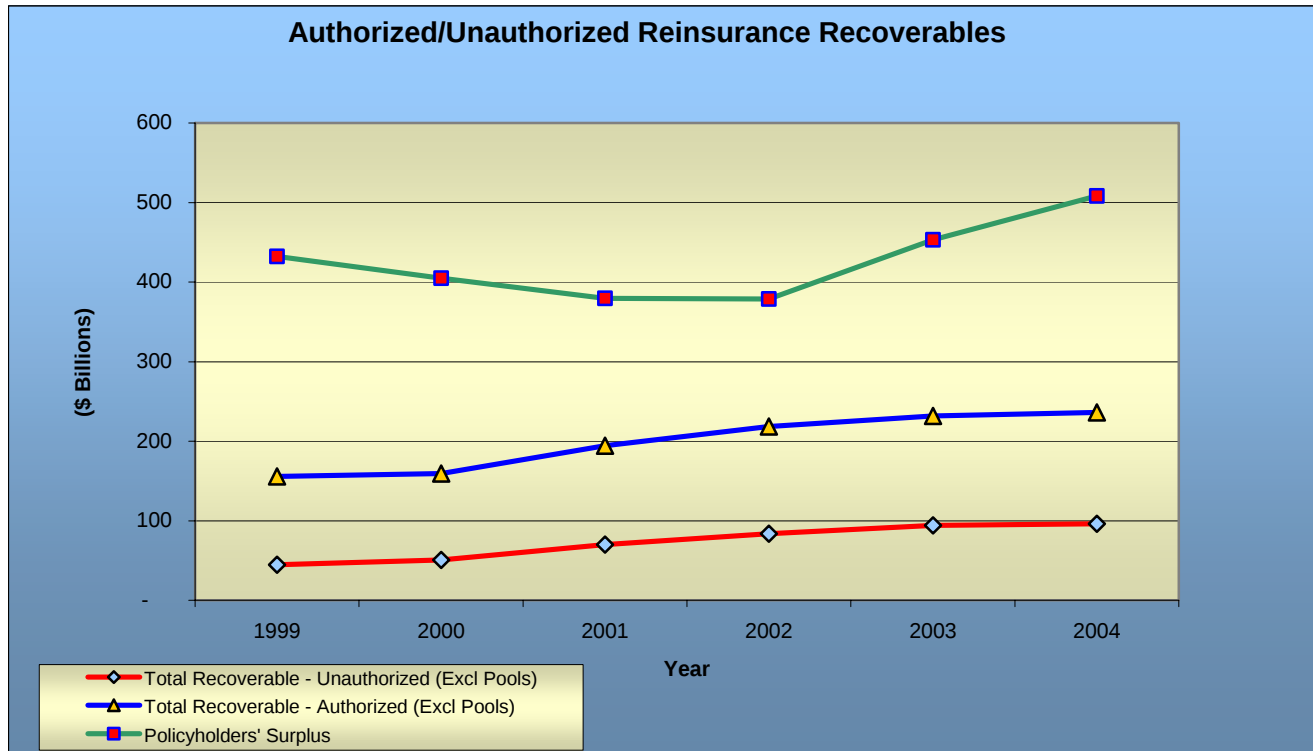
compensation, other liability, product liability, auto liability, auto physical damage, aircraft, fidelity, surety, burglary and theft, boiler and machinery, credit and international of the foregoing lines. The figures cited represent total recoverables, excluding recoverables from all pooling arrangements.

⁶ The Compound Average Growth Rates are calculated from combined (not consolidated) industry totals.

⁷ The \$508.3B is on a combined industry basis, it would be approximately \$404B on a consolidated basis.

Figure 2 - Property/Casualty Reinsurance Authorized and Unauthorized Recoverables (Excluding Pools) Compared to Policyholder Surplus

(\$U.S.)



Source: National Association of Insurance Commissioners

Fundamentals of Reinsurance

A reinsurance agreement is a contract between insurance companies. A ceding insurer transfers risk to an assuming reinsurer, the insurance company (or companies) that assumes all or part of the risk of one or more insurance policies issued by the cedent. Reinsurance agreements may be negotiated either directly with a reinsurer or arranged through the use of a third-party, a reinsurance broker or intermediary. Reinsurers, themselves, also purchase reinsurance protection, principally for the purposes of further spreading risk and reducing the impact of catastrophic loss events. This is called retrocession.⁸

Reinsurance agreements are contracts of indemnity in that the reinsurer's obligation arises only when the company's liability under its original insurance policy or reinsurance agreement has been incurred. The extent of that obligation is defined by the specific terms and conditions of the applicable reinsurance agreement. Absent specific agreement to the contrary (for example, a "cut-through" provision in which the obligations of the reinsurer will be paid directly to the insured or claimant under the original policy), there is no privity of contract between the reinsurer and any party other than the company defined as the "reinsured" in the reinsurance agreement.

⁸ For additional terminology and definitions, please refer to Appendix I – Glossary.

Reinsurance transactions in the insurance industry are becoming increasingly complicated. Companies may employ numerous reinsurance transactions with a variety of specific details, but typically, there are seven basic explanations to account for the companies' desire to engage in reinsurance:

1. Expand the Insurance Company's Capacity – Insurance company capacity is the maximum amount of risk the insurer can undertake in accordance with the company's surplus. By engaging in reinsurance transactions, companies are able assume more risk and obtain premium income while transferring a portion of the insurance risk to assuming companies.
2. Stabilize Underwriting Results – Significant individual losses have the capacity to worsen the insurance company's overall underwriting results. By engaging in reinsurance the insurance company has the capability to limit the impact of these individual large losses on its overall underwriting results by transferring a portion of the risk to other companies.
3. Financing - Statutory accounting rules prohibit the capitalization of acquisition expenses. Although the revenue from the insurance policy is earned over the policy term, the commissions paid to agents for new or renewed insurance policies must be recognized immediately. As this directive could put a financial strain on insurance companies, the commission allowances permitted under specific types of reinsurance transactions may assist in alleviating the strain on the company's surplus.
4. Provide Catastrophe Protection – Insurance companies may provide insurance for various types of perils in which one act may significantly impact numerous insurers for extensive amounts. It is vital for insurance companies to remain solvent by minimizing the financial impact of a single catastrophic loss occurrence (e.g., 1 in 250 year storm event).
5. Withdraw from a Line or Class of Business – Insurance companies may decide to stop writing a particular line or class of business. The insurer can transfer, or retroactively cede, risks to reinsurers that will assume the obligations of the primary insurer.
6. Spread of Risk – Reinsurance permits companies to lessen surplus strain and improve their capacity levels. It also enables companies to increase the amount of risks assumed and policies written as well as provides opportunity to engage in various types of risks among classes and businesses. This provides the company with the opportunity to improve the stability of underwriting risks and overall performance.
7. Expertise – Insurance companies may look to reinsurers for advice and counsel concerning underwriting guidance and information on forms, rates and loss experience on lines of business the company is considering entering. Companies may also look to their reinsurers for guidance concerning investments, personnel recruiting, claims reserving, engineering and acquisition of other companies.

Reinsurance, reduced to fundamentals, is therefore a contractual promise to pay, which depending on the type of insurance business ceded will not be presented for collection until long after the contractual obligations are created (primarily with respect to casualty/liability lines of business). As the primary insurance is not relieved from its obligation to its policyholder, the ceding entity is compelled to indemnify its policyholder irrespective of whether the reinsurance fulfills their contractual "promise to pay".

Long-term continuity has historically been an important element in reinsurance relationships. The reinsurance agreement entered into today is quite likely to have a financial impact on both parties that may persist over many years. The ultimate underwriting result on the contract may not become fully apparent until long after the agreement itself has expired or been terminated. However, the reinsurance arena is increasingly becoming more transaction-driven rather than relationship-based, which increases the importance of ensuring that adequate protections are explicitly and clearly incorporated into the contract at the outset.

Close attention must be paid to the nature and structure of the company's reinsurance arrangements, since they can have a substantial impact on the company's operating results and overall financial condition. Evaluation of the quality of reinsurance partners and the degree to which the company's surplus is leveraged by reinsurance recoverables should be given a high priority in every regulatory examination.

The U.S. regulatory community has long-recognized the need for both U.S. and non-U.S. reinsurance capacity to fulfill the needs of the U.S. marketplace. Consequently, the U.S. has developed a system of reinsurance regulation that has led to the development of an open but secure reinsurance market where nearly half of the reinsurance premiums are reinsured outside the U.S.⁹ According to 2004 NAIC statistical data, reinsurance premium was ceded to approximately 2,300 reinsurers. Approximately 60 countries receive U.S. premiums, although 96.4% of reinsurance premiums ceded outside of the U.S. go to the top 10 countries and 85% to the top 4 countries¹⁰.

Current Credit for Reinsurance Rules in Place

The regulatory approach to reinsurance in the United States has traditionally been focused on the ceding company's reinsurance arrangements and the specific provisions in its reinsurance agreements. From the regulator's perspective, the overriding concern is with the cedent's solvency, the impact of reinsurance on the ceding company's financial condition, and ultimately the financial impact on consumers of insurance products.

The basis for this approach is based on a presumption that there exists some relative equality of negotiating leverage between the buyer and seller of reinsurance products; this may not be entirely true in every instance, but the assumption that the buyer of reinsurance is less in need of regulatory intervention or protection than the average buyer of personal auto or homeowners or life insurance coverage is probably not unreasonable. In other words, the reinsurance contract is entered into between two sophisticated parties each of which are fully aware of the risks and rewards associated with such contract. Market conduct concerns relating to rate and form filing are therefore not a primary concern for regulators in the context of the reinsurance marketplace.

A major challenge for U.S. regulators lies in the fact that much of the reinsurance ceded by U.S. companies goes to reinsurers domiciled outside the U.S. Many of the largest, oldest, and financially strongest reinsurers are located abroad, and the capacity they provide is very important to U.S. ceding companies. Since U.S. regulators do not directly regulate them, however, U.S. regulators decided in the

⁹ Reinsurance Association of America, *Alien Reinsurance in the U.S. Market 2004 Data* (2005).

¹⁰ NAIC Schedule F data: 56 jurisdictions with cessions above de minimus levels.

past that statutory accounting rules and the laws regarding credit for reinsurance should require that all amounts recoverable from such reinsurers must be properly collateralized. The means of collateralization include letters of credit issued by authorized U.S. financial institutions, establishment of a single beneficiary trust or a multiple beneficiary trust (which also requires additional trustee surplus) in this country for the benefit of U.S. ceding insurers, or through the creation of funds withheld by reinsured companies. Any amounts that are not so collateralized may not receive a credit on the ceding company's balance sheet, and therefore, represent a direct deduction from the cedent's statutory surplus.

The Credit for Reinsurance laws,¹¹ statutory accounting requirements and procedures applicable to reinsurance transactions serve to provide regulators with an effective method of monitoring the reinsurance activities of U.S. companies. While there is nothing to prevent a company from transacting reinsurance business with any other company anywhere in the world, a U.S. ceding company will not be permitted to take statutory credit, that is to reduce liabilities by the amount ceded to reinsurers, or paid loss amounts recoverable from reinsurers as an asset on its balance sheet, unless such reinsurers meet one of the following requirements:

1. The reinsurer is licensed in the same state of domicile as the ceding company for a like kind of business. For example: A U.S. or a non-U.S. reinsurer (through a branch or an affiliate) can become licensed in one of more jurisdictions for writing certain classes of business. A personal lines primary insurer would receive credit for reinsurance for those policies reinsured by licensed reinsurers for those same lines of business.
2. The domiciliary insurance department of the ceding company accredits the reinsurer. Requirements of becoming accredited include:
 - a. Submitting to enacting state's jurisdiction.
 - b. Submitting to enacting state's examination authority.
 - c. Reinsurer must be licensed in at least one state.
 - d. Reinsurer must file its annual financial statement in ceding company's domiciliary state.
 - e. Maintain policyholder surplus of at least \$20 million.
3. The reinsurer is domiciled and licensed in a state with substantially similar credit for reinsurance laws as the state of the ceding company.
4. The reinsurer provides collateral in the form of a multiple beneficiary trust.
5. The reinsurer provides collateral or other security to the ceding insurer.

In order to satisfy the 4th condition, the trust must be established for the benefit of all U.S. ceding insurers, hence its reference to a 'multiple beneficiary trust.' A single assuming reinsurer setting up a MBT must provide collateral to secure its gross liabilities to all U.S. ceding insurers plus a \$20 million trustee surplus. In the case of Lloyd's, the trust fund must secure its gross liabilities plus a \$100 million

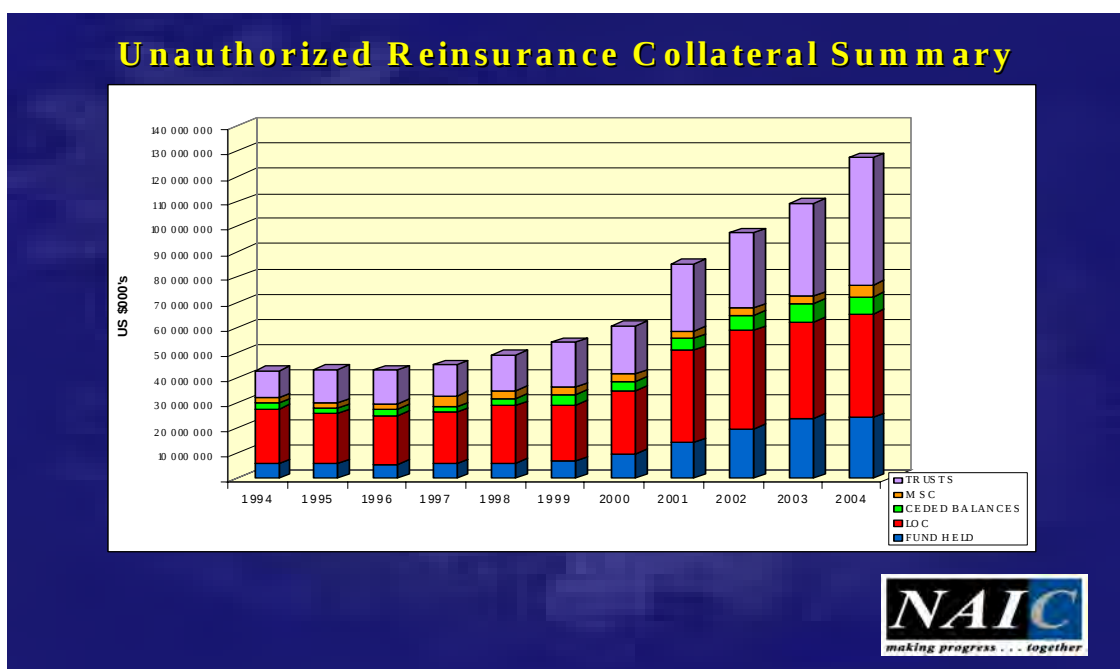
¹¹ See the NAIC Credit for Reinsurance Model Law and Regulation in Appendix V and VI. The Credit for Reinsurance Model Regulation provides additional details to the credit for reinsurance model law. It contains guidance on valuing assets and additional trust fund requirements and has been adopted in all 50 States.

trusteed surplus. To satisfy the 5th condition, an unauthorized reinsurer must post collateral which is typically in the form of a separate trust account or a designated LOC, in either case issued on behalf of the unauthorized reinsurer with the cedant as the designated beneficiary. Alternatively, the ceding insurer may maintain funds on a “funds withheld basis”. A non-U.S. reinsurer may not wish to obtain a licence in the states though, for the reasons outlined above, which make cross-border trade a preferred operating model for many reinsurers, including U.S. domiciled reinsurers. Furthermore, Lloyd’s is a market and not a company and cannot, therefore, set up a U.S. branch or affiliate. For the reasons mentioned above, non-U.S. reinsurers cannot utilize this provision, because they do not have a license in another U.S. state and the law does not recognize a domiciliary license outside of the U.S.

Options for Funding Under Credit for Reinsurance Rules in Place

There are costs involved with maintaining LOC’s and trust funds and while the actual cost is funded by to the reinsurer, it is built into the price paid by the buyer of reinsurance coverage. The best form of collateral for purposes of quick and efficient collection is LOC’s with reinsurance trusts as the next best alternative. The benefits of collateral are that it enables a quick and efficient collection of a valid enforceable claim, if the reinsurer does not pay it. The use of LOCs is well understood in the commercial world with the trust deed allowing a valid, enforceable unpaid claim to be paid on presentation to the trustee bank, under the supervision of the U.S. state regulator concerned.

Figure 3 - U.S. Reinsurance Collateral Summary
(\$ 000’s)



Letters of Credit

A letter of credit (LOC) is a document issued by a bank at the request of the unauthorized reinsurer (the “account party”), which stipulates that the bank will honor any draft presented by the beneficiary pursuant to a reinsurance agreement between the account party and the beneficiary. In accordance with Credit for Reinsurance laws, the LOC must be:

- “Clean” (*i.e.*, not subject to any other documents conditions or to any limitations, other than its face amount, and not dependent on reimbursement from the account party)
- Irrevocable (not cancelable prior to its stated expiration date)
- “Evergreen” (with a clause providing for automatic extensions, twelve months at a time, unless at least 30 days’ advance notification of intent not to extend the LOC has been provided to the beneficiary).
- Issued or confirmed by a qualified U.S. financial institution (the Securities Valuation Office (SVO) of the National Association of Insurance Commissioners (NAIC) maintains a listing of such institutions).

These conditions make performance on the LOC dependent only on the solvency of the issuing bank, regardless of the financial condition or willingness to pay of the reinsurer. Therefore, LOC's have been a reliable method of securing the obligations of unauthorized reinsurers. In reviewing the company's collateral arrangements, U.S. regulators verify that the LOC issued on behalf of any unauthorized reinsurer is an amount at least equal to the amount of annual statement credit taken as respects to reinsurance ceded to that reinsurer, and all LOC's bear effective dates no later than the date of the most recent financial statement on which credit for reinsurance ceded to the unauthorized reinsurer has been taken.

According to anecdotal reports, the administrative costs associated with maintaining LOC's for the benefit of the cedent average between 40 – 60 basis points depending on the creditworthiness of the company, the bank's capacity to issue LOC's and other factors. This is an increase from years ago where the cost was about 25 bps. As can be seen in the next graph, many cedants have moved to other forms of collateral such as trust funds, where the cost can be less (15-45 bps, for example), or to funds held accounts where there is little cost to either party such as additional accounting with respect to the fund balance. These costs exclude the capital costs to reinsurers and the burden of maintaining collateral at a gross reserve level.

Figure 4 – Collateral by Type

Reinsurance Collateral by Type and Growth Rates (Compounded Avg.)			
	<u>% of Total</u>	<u>10 year</u>	<u>5 year</u>
Other (Trust)	39.8	16.8%	23.6%
LOC's	32.3	6.5%	13.0%
Funds Held	18.9	15.2%	28.0%
Ceded Bal.	5.5	12.9%	11.6%
Misc.	<u>3.5</u>	<u>7.7%</u>	<u>8.5%</u>
Total	100.0	11.6%	18.7%

Source: National Association of Insurance Commissioners



Trust Funds

Single Beneficiary Trust

An unauthorized reinsurer can provide individual collateral (through a trust, letter of credit or other acceptable security) to each of its ceding insurers without the necessity of a surplus amount in addition to its obligations. The vast majority of reinsurance collateral is funded via trusts or LOC's that are negotiated with an individual beneficiary.

Multiple Beneficiary Trust

Unauthorized reinsurers may also establish MBT's, which will allow them to fund all of their U.S. liabilities through one trust instead of establishing dozens or perhaps hundreds of individual trusts. In order for unauthorized reinsurers to qualify for setting up the MBT, entities are also required to fund a surplus of \$20 million, except for Lloyd's, which collectively funds a \$100 million surplus amount. That allows all Lloyd's underwriting members to participate and fund their U.S. reinsurance liabilities through their own multi-beneficiary trusts that are held in bank accounts administered for each of the 99 syndicates whose members hold these funds. The Lloyd's credit for reinsurance trust funds are currently valued at \$ 7.39 billion. Other unauthorized reinsurers that have chosen to do business in the U.S. using MBT's collectively owe U.S. ceding insurers nearly \$ 7.14 billion, based on data received from the New York Department of Insurance as of December 31, 2004.¹² An MBT can also be used as a vehicle for a

¹² The following non-U.S. entities choose to maintain multiple beneficiary trust funds: Aspen Insurance, UK Limited; AXA Corporate Solution Assurance; AXA Re; CX Reinsurance Company Ltd.; Hannover Ruckversicherungs; Lloyd's; Sphere

multibeneficiary LOC, because an LOC may be counted as an “asset” of the trust under the Credit for Reinsurance Model Regulation. Reinsurers establishing a MBT are also subject to a significant level of direct regulation by U.S. regulators that requires, (a) filing quarterly reports of detailed financials to evidence adequacy of the MBT, (b) providing details of retrocessions and (c) filing audited annual reports where the reinsurance reserves have been certified by a qualified actuary and (d) submission to the authority of the U.S. regulator conduct examination.

According to the Chief liquidation officer for Reliance, the ability to collect from a MBT has been challenging due the administrative burdens inherent in such an attempt. Although the trustee surplus is designed to ensure that there are sufficient funds to satisfy all claims, there is a risk that MBT’s may be grossly under funded in the event of an insolvency of the unauthorized reinsurer. While an authorized reinsurer’s surplus varies based upon the liabilities it assumes under the risk based capital requirements, the requisite trustee surplus for MBT’S has remained static for years even though the liabilities secured by those MBT’s may have grown enormously.

Quality of Reinsurance can be a Solvency Risk

As U.S. regulators do not have the authority (jurisdiction) to collect reinsurance from offshore reinsurance companies in the case of cedant insolvency, it is imperative that certain protections are in place to insure a cedant will be able to meet its obligations to policyholders.

The 2004 NAIC Property/Casualty Risk-Based Capital Formula includes a 0.100 factor for all reinsurance recoverables after reducing the balance sheet amount by the Schedule F Penalty that is calculated for these recoverables. A stratification of receivables by reinsurer rating with differing charges assigned to different rating is not supported in the current formula.

The total amount of collateral held has increased from \$43.5 billion in 1995 to \$127.4 billion in 2004 for a compounded average increase of 12.7%. This represents 38.3% of the total reinsurance recoverables at 31 December 2004 when excluding all pooling transactions. As reinsurance claims have increased, so too have the collateralized amounts increased and the potential solvency impact of collateral as well as the potential solvency impact due to the increase in this particular risk (i.e. for the class of reinsurance business). The U.S. insurance marketplace depends upon the availability and affordability of adequate reinsurance. Inexpensive reinsurance, however, is no bargain if it fails to respond when called upon, whether it is purchased from authorized or unauthorized reinsurers. This is not just a theoretical concern; unrecoverable reinsurance has been an ingredient in some of the largest insurance insolvencies. In a 2004 insolvency study, A.M. Best noted that:

Reinsurance failure has only caused 3.7% of the insolvencies from 1969-2002. This occurs when a company’s reinsurer does not fulfill its contractual obligation for payment of reinsured claims. This emerged as one of the leading causes of impairment in the mid-1980’s (3rd leading cause of insolvency at 10.1% from 1984-1990) when some reinsurers experienced financial difficulty or insolvency, primarily as the result of cash flow underwriting. Reinsurance failure was also cited as a cause of impairment for some companies that purchased the least expensive reinsurance

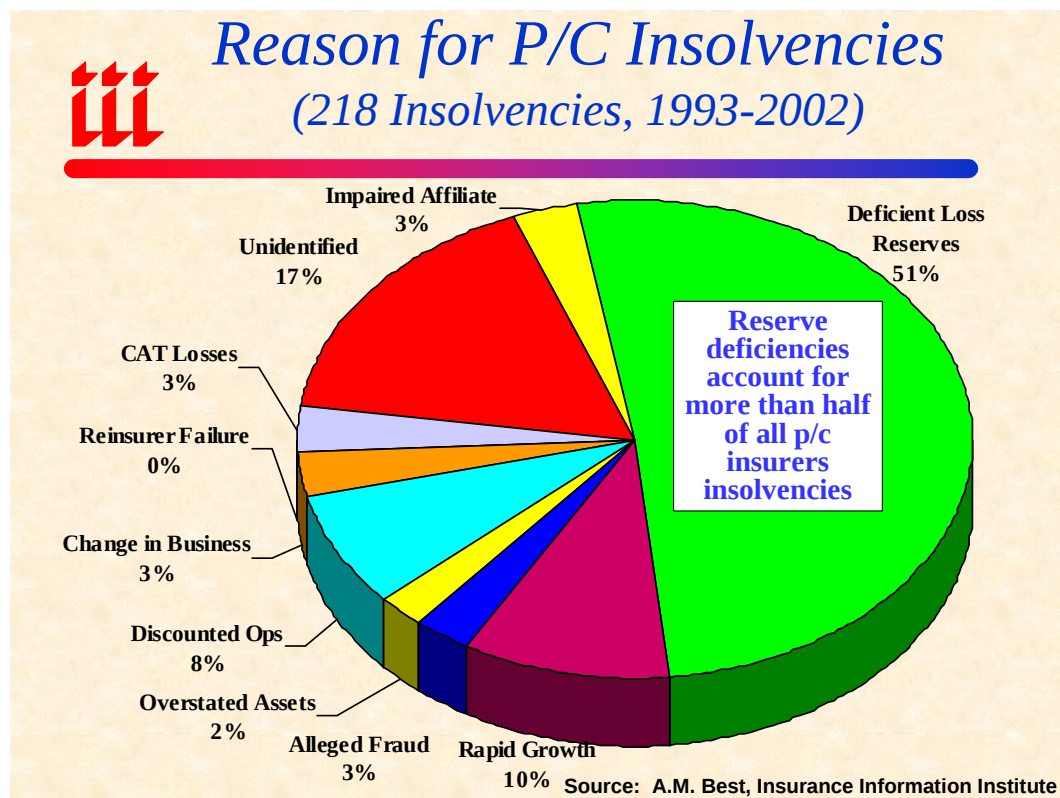
Drake Insurance Ltd.; St. Paul Reinsurance Company Ltd.; Markel International Insurance Company Ltd.; Unionamerica Insurance Company; Zurich Specialties London Ltd.

protection without sufficient regard to financial strength of the reinsurer. In the 1990's and 2000's, reinsurance failure was not a primary factor in impairment due to a flight to quality among ceding companies and a more disciplined reinsurance market with higher capitalization and tighter reinsurance coverage terms.

This could change. Despite improved pricing since 2001, reinsurer capitalization generally has remained stressed due to a number of factors, including evaporation of hidden assets (European reinsurers), adverse reserve development, particularly in casualty classes (U.S. reinsurers) and devaluation of equity holdings. This has led to a significant deterioration in capitalization, resulting in a number of rating downgrades. A.M. Best has some concern that weaker reinsurance companies could be more susceptible to failure due to those current market issues.¹³

An A.M. Best review for the period 1993-2002, however, showed that uncollectible reinsurance was the cause of 0% of the 218 insurance insolvencies in the U.S..

Figure 5 – Reason for P/C Insolvencies 1993-2002



Reinsurance collections have become a more difficult and contentious process where the willingness to pay seems to be as big an issue as the ability to pay. Collections in a liquidation environment are even more difficult. Receivers have reported that having access to collateral makes a tremendous difference in the collection process, both in getting timely responses to billings and other correspondence as well as

¹³ A.M. Best Company, *Best's Insolvency Study: Property/Casualty U.S. Insurers 1969-2002*; May 2004.

tempering the extreme positions taken by some reinsurers. In some cases, collections from unauthorized reinsurers have been easier due to the existence of the collateral than collections from authorized U.S.-based "professional" reinsurers. The experience of Legion and Reliance both demonstrate the role that collateral plays in protecting the cedent in the case of insolvency.

Legion (along with its affiliate Villanova) was placed into rehabilitation in April 2002 and into liquidation in July 2003. Since that time, 82% of the Legion group's recoveries (\$207M out of \$252M) have been from unauthorized reinsurers that have collateralized balances. According to the chief liquidation officer, authorized reinsurers have only paid about \$5 million from collateral during that same time period. At the present time, Legion has \$343 million of overall net unsecured U.S. reinsurance recoverables on paid losses while the non-U.S. figure is negative \$18 million on a net basis.

Liquidators and arbitrators are reportedly less comfortable with the operation of the MBT's, because there are no accounts of drawdowns from the trusts. Lloyd's and Hannover Re's MBT's are structured as funds of last resort that would only be accessed if these reinsurers failed to meet their obligations as they fell due. The process that would be used is modeled on the LOC drawdown process. The trust deeds clearly provide that any valid enforceable claim would be paid on presentation to the trustee, following notice to the state regulator concerned. The standard of proof process for an enforceable unpaid claim is the same as it would be to compel payment from a U.S. licensed reinsurer.

Nonetheless, practical difficulties exist with getting funds from MBT's. Companies must go through the entire claims process first in order to put a claim into the trusts. For example, liquidation officers have indicated that the process of collecting from a MBT is extensive, expensive and time consuming. Unlike a LOC, which can be quickly and easily drawn and collected upon, it can take years and significant expense to collect from a MBT. The process of collecting from Lloyds MBT is first to meet the contractual requirements for submitting proofs of loss, which almost no reinsurer honors for an insolvent cedent, requiring many rounds of documentation and explanation far beyond contractual requirements. When the cedent finally loses patience at this vexatious conduct, an arbitration demand is the only resort. After getting an award (which can take 18 months to 2 years), they must file for a confirming award in a court and weather possible appeals. Once you have an unappealable award you must initially try to collect from Names, and then the Central Fund, all without success, and then finally you try to access the Lloyd's MBT. What liquidator or cedant in their right mind would go through that process. Other MBT's work similarly. An alternative approach would be that once the reinsurer fails to make payment pursuant to the contract requirements, a cedent should be able to present an affidavit to the MBT and collect, and if the reinsurer disagrees, then let them file the arbitration to collect funds from the cedant or prevent funds from being disbursed to the cedant. Legion has been successful with an arbitration panel in getting the Lloyd's reinsurers to post letters of credit so that Legion could be easily paid at the end of the hearing. The arbitration panel recognized how difficult it was to draw from the Lloyd's MBT and awarded Legion security in the form of a letter of credit.¹⁴

In Legion's liquidation scenario, far more often than not, LOC's are frequently drawn down for claim payments. Liquidation officers have indicated that reinsurers more often would prefer to draw down LOC's so that they don't increase their already stipulated security amount exposed to the liquidated estate. Prior to a liquidation scenario, it may be true that a reinsurer would rather pay than have the

¹⁴ Lloyd's rebuts some of the criticism from liquidation officers and sets out the process applied by Lloyd's to pay valid claims in the arguments section **Timing of Funding, Claims Payments and Withdrawals**.

reinsured draw from the LOC, as there are associated bank charges (and when the relationship is ongoing, the need to secure new liabilities as they are incurred); however, the collections are still clearly certain in that event.

With respect to trusts, liquidation officers have indicated that the same basic experience occurs. Some trusts require evidence of the claim payments, but there are usually no transaction charges, so fund withdrawals in a non-liquidation scenario are actually more common than with LOC's.

Reliance Insurance Company reportedly experienced a significant slowdown in reinsurance collections when it entered rehabilitation and then liquidation. Reliance has over \$3 billion of reinsurance recoverables with approximately 80% (\$2.4 B) from authorized reinsurers. Collateral supporting those recoverables is \$900 million (30% of gross liabilities with U.S. unauthorized reinsurers posting 10% of the total and non-U.S. unauthorized reinsurers posting the remaining 20%).

Even with collateralized reinsurance, recoveries will be insufficient to cover all liabilities because the collateral amounts may not ultimately cover all future outstanding liabilities if there is adverse loss development after the estate enters liquidation. Due to the inherent difficulty that arises in reinsurance collections, liquidators have indicated that the likely result from a collateral reduction is further increased expenses and lower asset recoveries for liquidation estates.

Reinsurance Market Analysis

Market share/concentration

The RAA have estimated that in 1997, the U.S. “professional reinsurers” share of the market was 61.6%, declining to 51.8% in 2004¹⁵.

According to A.M. Best’s 2004 Aggregate & Averages – Property/Casualty the market share of all U.S. reinsurers is 65% (\$42bn) and of all non-U.S. reinsurers is 35% (i.e. \$23bn). Analysis of the relative market-share of non-U.S. and U.S. is complicated by the international nature of the market place and the fact that cessions are often made between affiliated companies.

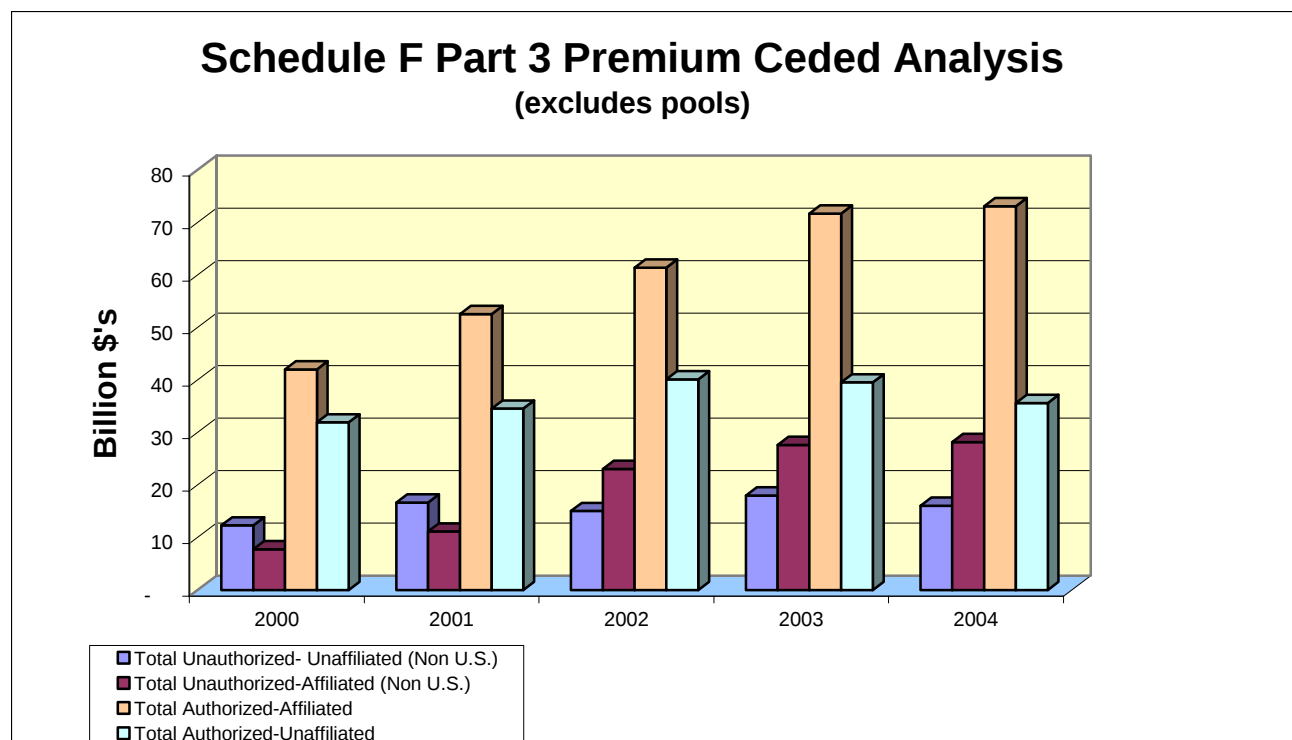
The RAA has estimated that if U.S. subsidiaries of alien reinsurers are excluded, the U.S. professional reinsurers share drops to 15.2%.

According to A.M. Best’s 2004 Aggregate Averages Property/Casualty, the market share of U.S. reinsurers, (including affiliated cessions made from overseas subsidiaries to U.S. parents) was 85% (\$299bn)¹⁶ and the market share of non-U.S reinsurers (including affiliated cessions made from U.S. subsidiaries) was 15% (i.e. \$53bn).

¹⁵ Reinsurance Association of America, *Alien Reinsurance in the U.S. Market 2004*. See criteria applied in the RAA Report to determine “U.S. professional reinsurer” and that it was not possible to apply such criteria to non-U.S. reinsurers.

¹⁶ \$299B figure is not consolidated and includes \$188B of premiums attributable to intercompany pooling arrangements.

Figure 6 - Premium volume (affiliated/unaffiliated, authorized/unauthorized)



Source: National Association of Insurance Commissioners

As can be seen in Figure 6 above, the premium ceded to affiliated authorized and unauthorized reinsurers is increasing much more rapidly than unaffiliated authorized and unauthorized reinsurance. The unauthorized unaffiliated premiums have increased at an average annual rate of 8.2% (on a compounded basis) over the last 5 years while the affiliated premiums have increased at a 26.5% rate over that same time period primarily due to the increase of affiliated business being ceded to parent companies in Bermuda and Europe. In addition, authorized affiliated reinsurance premiums have increased at an average annual increase of 11.7% while the same figure for unaffiliated premiums grew at a 2.2% pace.

According to NAIC annual statement data, more than 4,000 reinsurers from 100 countries either assumed premium or owed recoverables to U.S. insurers in 2004. Approximately 2,300 of the more than 4,000 actually assumed premiums. Further analysis of NAIC data shows that reinsurance premiums were actually ceded to approximately 56¹⁷ countries: 96.4% (\$44.3B) of these premiums went to reinsurers in the top 10 jurisdictions and over 85% (U.S.\$ 39.1B) to the top 4 jurisdictions. (See chart below). Excluding mandatory and voluntary pools, the overwhelming amount of unaffiliated premium (\$20.8 billion of \$21.9 billion) went to and reinsurance recoverables (\$51.5 billion of \$53.6 billion) were due from reinsurers in 10 key countries.¹⁸

¹⁷ NAIC Schedule F data: based on 56 countries with more than de minimus premiums

¹⁸ The graphs show the unaffiliated and affiliated premiums ceded and recoverables for U.S. insurers. The number in parentheses is the 5 year compounded average increase (+) or decrease (-) for each jurisdiction.

Country	Premium ceded to non-U.S. unaffiliated reinsurers 2004 {5 yr.}	Country	Recoverables from non-U.S. unaffiliated reinsurers 2004 {5 yr.}
Bermuda	\$ 7.8 billion {+ 12.0%}	Bermuda	\$ 12.6 billion {+ 10.4%}
United Kingdom	\$ 4.1 billion {+ 3.9%}	United Kingdom	\$ 12.1 billion {+ 2.6%}
Germany	\$ 2.9 billion {+ 22.5%}	Ireland	\$ 6.7 billion {+25.0%}
Cayman Islands	\$ 1.6 billion {+ 19.9%}	Germany	\$ 5.5 billion {+ 17.6%}
Switzerland	\$ 1.5 billion {+ 45.3%}	Switzerland	\$ 5.3 billion {+36.3%}
Ireland	\$ 0.9 billion {+ 5.7%}	Barbados	\$ 4.1 billion {+ 5.6%}
Barbados	\$ 0.8 billion {+ 2.9%}	Cayman Islands	\$ 2.6 billion {+17.5%}
Turks and Caicos	\$ 0.4 billion {+ 7.2%}	France	\$ 1.3 billion {- 4.6%}
France	\$ 0.4 billion {- 4.2%}	Japan	\$ 1.0 billion {+ 1.4%}
Japan	\$ 0.3 billion {- 0.2%}	Turks and Caicos	\$ 0.4 billion {+25.1%}
Total	\$20.8 billion {+ 11.3%}	Total	\$51.5 billion {+ 10.7%}

There are similar geographic concentrations when analyzing affiliated reinsurance with 98.6% of all affiliated ceded premium going to and 99% of all recoverables due from the following jurisdictions:

Country	Premium ceded to non-U.S. affiliated reinsurers 2004 {5 yr.}	Country	Recoverables from non-U.S. affiliated reinsurers 2004 {5 yr.}
Bermuda	\$ 17.0 billion {+26.8%}	Bermuda	\$ 26.0 billion {+22.1%}
Switzerland	\$ 7.8 billion {+ 75.7%}	Switzerland	\$ 10.9 billion {+47.0%}
Germany	\$ 3.3 billion {+ 50.9%}	Germany	\$ 7.6 billion {+50.9%}
Barbados	\$ 0.9 billion {+ 32.2%}	Cayman Islands	\$ 2.1 billion {+ 10.1%}
Cayman Islands	\$ 0.6 billion {- 7.9%}	United Kingdom	\$ 2.0 billion {+24.0%}
United Kingdom	\$ 0.3 billion {- 4.7%}	Barbados	\$ 1.3 billion {+6.5%}
France	\$ 0.2 billion {+ 11.5%}	France	\$ 1.2 billion {- 3.5%}
Canada	\$ 0.2 billion {+ 41.2%}	Ireland	\$ 0.6 billion {- 12.2%}
Turks and Caicos	\$ 0.2 billion {- 22.4%}	Japan	\$ 0.4 billion {- 3.3%}
Ireland	\$ 0.2 billion {N/A%}	Canada	\$ 0.3 billion {+88.1%}
Total	\$30.7 billion {+ 30.6%}	Total	\$52.5 billion {+24.9%}

Standard and Poor's also publishes an annual Global Reinsurance Highlights Report. The 2005 edition identifies the top 40 global reinsurance groups as measured by net reinsurance premiums written. While this report underscores the international nature of the reinsurance market, it also illustrates the small

number of wholly owned U.S. reinsurance corporations. Since 33 of the top 40 reinsurance groups are domiciled outside the U.S., it stands to reason that a large market share is held by non-U.S. reinsurers (directly or ultimately controlled through off-shore parent corporations). Of the top 40 reinsurance groups, 13 are domiciled in Bermuda; 12 are domiciled in Europe; 7 are domiciled in the U.S., and 5 are domiciled in Japan. Since this group includes both life and non-life, it may be useful to look at the same report of the top 10 non-life reinsurance groups. Of these 10 companies, 7 are domiciled outside of the U.S (6 in Europe and 1 in Barbados) and three are domiciled in the U.S.

Collectibility of Reinsurance Recoverables

The ultimate recoverability of reinsurance balances by the ceding company, and the timeliness of recoveries, has also become a matter of regulatory concern. Reinsurance balances recoverable from the company's reinsurers should be evaluated just as any other receivable would be: based on the perceived financial condition of the reinsurer, what is the likelihood that the company will recover all of the amounts recoverable from that reinsurer in a timely manner, consistent with the actual payment of claims under the policies reinsured, or as otherwise specified by the terms of the reinsurance agreement? Several revisions to the U.S. annual statement reinsurance schedules were designed to provide strong motivation to ceding companies to do everything possible to accelerate the collection process. The statutory penalties for delinquent reinsurance recoverables do not appear to have had the intended effect of accelerating cash recoveries, as measured by the total penalty amount for all companies reporting, expressed as a percentage of industry surplus. It should be noted that this penalty applies to overdue balances from both U.S. and non-U.S. reinsurers. Recoverables that are in excess of 90 days overdue will incur a 20% reserve or allowance. In addition, overdue recoverable amounts that exceed 20% of all recoverables on paid losses create an annual statement penalty of 20% of those recoverables. These penalties will directly impact the company's surplus position. Recoverables in dispute were not considered overdue, since the cause for non-payment is uncertainty about the reinsurer's liability, not tardiness. However, regulators noted that a ceding company could avoid the penalty for overdue recoverables by classifying them as "in dispute", so a provision of 20% of amounts in dispute was added in 1993. Therefore, reinsurers that are slow-paying are treated like unauthorized reinsurers, except that the statutory penalty is the greater of 20% of the unsecured recoverables and 20% of the overdue amounts, not the sum of these two amounts. For slow-paying authorized reinsurers, the unsecured recoverables include amounts in dispute.

Overdue Recoverable on Paid L & LAE % of Adj PHS			
	Overdue Recoverable	Adjusted PHS	Overdue Rec. % of Adj PHS
1997	3,567,773	324,084,122	1.1%
1998	3,597,841	343,192,963	1.0%
1999	3,659,232	346,979,158	1.1%
2000	4,949,344	329,823,928	1.5%
2001	5,305,798	300,915,643	1.8%
2002	5,539,577	297,995,175	1.9%
2003	6,799,993	365,796,759	1.9%
2004	6,763,006	413,353,862	1.6%

As can be seen with the chart below, the past due balances have been increasing significantly for authorized reinsurers compared to unauthorized reinsurers. In the period 2002 to 2004, authorized reinsurers' overdue balances increased by 50%, whilst unauthorized reinsurers' balances remained relatively stable.

Figure 4 – 2004 Overdue Balances for the P & C Industry

P&C Industry Past Due 2004

(000's)	2004	2003	2002
Auth > 91	210,429	202,537	154,842
Auth > 120	3,217,593	3,044,995	2,130,733
Total Auth	3,430,026	3,249,535	2,287,577
Unauth > 91	127,494	105,384	75,094
Unauth > 120	890,067	1,133,368	1,102,357
Total Unauth	1,017,561	1,238,752	1,027,263

Source: National Association of Insurance Commissioners

The following chart gives the largest overdue balances for unauthorized entities.

Figure 5 – Overdue Unauthorized Reinsurers

2004 Unauthorized Reinsurance Amounts 90+ Days Overdue (000's)

<u>Alien #</u>	<u>Company</u>	<u>Balance</u>	<u>% Inc/(Dec) from 2003</u>
AA-1122000	Equitas	359,176	12.6%
AA-1120355	Excess Casualty Reins	203,281	5.4%
AA-1126000+	Lloyd's (All Syndicates)	86,048	(34.1)%
AA-1120355	CNA Intl Reins	42,318	(7.8)%
AA-1120580	Excess Ins. Co. Ltd.	36,641	25.3%
AA-1780047	London Life	31,391	4.5%
AA-1120545	English & American	29,233	(35.5)%

Source: National Association of Insurance Commissioners

The provision for reinsurance with unauthorized companies consists of three parts: i) 100% of unsecured (total) recoverables; ii) 20% of overdue loss recoverables; and iii) 20% of amounts in dispute. If the

reinsurer is authorized, a test is performed for speed of payment. A slow-paying authorized reinsurer is accounted for like an unauthorized reinsurer, except that the provision for reinsurance is the greater of (i) 20% of the unsecured total recoverables (including amounts in dispute) and (ii) 20% of the loss recoverables more than 90 days past due.

The authorized reinsurer is not slow-paying if the ratio of loss recoverables more than 90 days overdue to all recoverables on paid losses and loss adjustment expenses plus amounts received in the last 90 days of the statement year is less than 20%. In these instances, the provision for reinsurance is the sum of:

- 20% of the loss recoverables more than 90 days past due, and
- 20% of the amounts in dispute

The following chart provides a listing of the 10 U.S. insurers with the largest overdue authorized reinsurance as of December 31, 2004:

Figure 6 – Overdue Authorized Reinsurers

NAIC #	Company	Balance	% Change From 2003	Overdue / PHS
10227	American Re	300,281	5 7%	13 9%
19453	Transatlantic Re	145,632	19 4%	9 5%
20583	NAC Reins Corp	118,395	29 6%	20 6%
20443	CNA Continental	97,132	105 6%	1 5%
23680	Odyssey America Re	90,722	49 3%	10 6%
61425	Trustmark Ins	89,953	24 0%	51 6%
22039	GEN Re	81,814	(41 2)%	1 8%
24902	Orion Ins	68,714	23 0%	30 6%
21032	Constitution Re	67,870	52 6%	13 9%
22969	GE Re Corp	64,064	16 5%	8 3%

It should be noted that some of the companies listed above have indicated that the majority of these balances should be considered payables in dispute, so while a statutory penalty exists for those balances, the entities would not want to be classified as a slow payer. (Transatlantic advised that 82% of the total is in dispute and American Re indicated that 67% of the total relates to a single dispute involving long tail asbestos liabilities that are the subject of court proceedings. Removal of this disputed amount would reduce the ratio of Overdue/Policyholders Surplus from 13.9% to 2.9%.)

History of Current Debate

Discussions at the NAIC concerning reinsurance regulation began in earnest during the late 1940's. . Regulators expressed concerns about abuses relating to reinsurance and whether or not annual statement reductions would be permitted. A questionnaire issued by the NAIC during this period of time resulted in responses from 46 states and territories. Those responses demonstrated that states varied significantly in their treatment of reinsurance. Although recommendations were made at the NAIC in 1950 as a result of this survey, essentially the same issues continued to be discussed three decades later.

In 1982, the Illinois Department of Insurance submitted a report to the NAIC that suggested the development of a model law on reinsurance which would create consistent financial standards for assuming reinsurers from state to state, accounting for reinsurance transactions and reserve credits, circumstances for prior approval of reinsurance arrangements, required provisions for reinsurance contracts and financial reporting and disclosure of certain reinsurance transactions. As a result of this work, the first model law addressing credit for reinsurance was adopted in June 1984 and amended and updated in 1991, 1996 and most recently in 2001.

In the mid-1990's, certain MBT reinsurers advocated various proposals to reduce the funding requirements for MBT's, including the funding of MBT's with letters of credit and the interpretation of the law as only requiring MBT's to be funded net of retrocession, not on a gross basis. At the 1994 NAIC Summer National Meeting of the Reinsurance Working Group, regulators agreed that all unauthorized reinsurance liabilities should be funded at 100% of gross liabilities with no reduction for any retrocessional protection, noting that it was not realistic to expect regulators to evaluate every unauthorized reinsurer's retrocessional agreements and that there was no requirement for those retrocessions to be collateralized. Through 2000, the primary focus of the unauthorized non-U.S. reinsurers was to request reduction only for those entities that maintained multiple beneficiary trust funds. In August 2001, the Reinsurance Task Force issued the following statement:

While the Reinsurance Task Force believes that a reduction in the collateral requirements for multi-beneficiary trust fund reinsurers deserves further consideration and may be an achievable goal at some point in the future, due to current conditions in the world financial markets and the property and casualty insurance markets, the Task Force does not believe that this is the appropriate time to make such a reduction. Rather, the Task Force would like to revisit this issue in approximately one year. During that time, the Task Force asks that Interested Persons continue its work on innovative feasible solutions to this issue and keep the Task Force informed of any developments regarding such solutions. Currently, the Task Force feels that the most promising (but not exclusive) solutions are (1) the reduction in collateral requirements for retrocessional protections (2) the U.S. insurer parental guarantee, and (3) the reduction for working funds concept. As part of this process, due to the unique qualities of the Lloyd's market, an alternative solution may potentially be foreseen for Lloyd's as compared to other multi-beneficiary trust fund reinsurers.

After the attacks of September 11, 2001, the Reinsurance Task Force received a proposal to establish an approved list of reinsurers that would not only potentially benefit multiple beneficiary trust reinsurers, but could apply to any unauthorized reinsurer that met the financial criteria for listing.¹⁹ From 2001-2003, the Reinsurance Task Force considered information on the three key issues: regulatory regimes in the countries of the major reinsurers, enforcement of U.S. judgments overseas and the comparison of U.S. accounting standards to international accounting standards. The Reinsurance Task Force received

¹⁹ The NAIC considered creating an Approved List for reinsurers nearly 20 years ago. At that time, regulators decided against it due to concerns that too little was known about foreign regulatory systems and the format and content of foreign financial statements to justify any reduction in credit for reinsurance collateral funding requirements, regardless of what information an applicant for Approved List status might provide. In January 2003, the NAIC's Insolvency Task Force considered the proposal to allow a reduction from 100% collateral for reinsurers that qualified for an "Approved List." After considering a number of factors, the Insolvency Task Force recommended rejection of the proposal and unanimously stated, "It does not support the proposal to reduce collateral requirements for U.S. reinsurance liabilities."

reports from sub-committees on these issues and discussed U.S. reinsurance collateral requirements for some time before asking the interested parties, in 2003, to hold their own informal discussions and attempt to formulate a consensus solution. The interested parties, who worked on this issue, were unable to reach a consensus in 2003. In March 2004, the NAIC Reinsurance Task Force adopted a resolution which deferred further consideration of any proposals “to allow time for the interested parties to work on alternatives for the regulators to consider” and which set forth the “goals of any future deliberations on this issue which are to ‘ensure consumer protections, enhanced solvency and security of insurers and encourage equitable treatment for both authorized and unauthorized insurers’”. Pursuant to this action, in March of 2004, nine U.S. regulators (the Participating Regulators²⁰) decided to establish the Ad Hoc Reinsurance Collateralization Roundtable (Roundtable) that would work outside of the Reinsurance Task Force’s charges and formal NAIC process to facilitate discussions between these regulators and senior executives from select U.S. and non-U.S. insurers, reinsurers and trade associations on possible alternatives to the current collateral requirements. In November 2004, following six months of initial work by the Roundtable the participating commissioners wrote to the participating industry representatives expressing their view that the credit for reinsurance rules should be changed and that the new rules should apply to all reinsurers. The Ad Hoc Roundtable Chairmen presented a final report on the Roundtable deliberations to the Reinsurance Task Force in December 2005. It indicated that although complete consensus among all members of the Roundtable was never achieved, there was substantial agreement that a system for rating unauthorized reinsurers according to financial strength and reliability was feasible, and that collateralization requirements could be varied according to the ratings. The Report set out a general structure for such a regime for NAIC consideration. In general, unauthorized reinsurers participating in the Roundtable favor amending the current credit for reinsurance law to provide rules that would assess the solvency of U.S. and non-U.S. reinsurers on the same basis. Certain Non-U.S. reinsurers also argued for U.S. regulators to recognize the prudential supervision of certain regulatory regimes outside the country., which they argue are as effective as the U.S.

²⁰ Arkansas, District of Columbia, California, Georgia, Illinois, Maine, New York, North Dakota, and Texas.

Collateral Issues – Synthesis of Arguments for and against change

Thus, the debate about reducing collateral has been ongoing for a number of years. This section of the paper attempts to recapitulate the numerous industry arguments pro change and pro maintenance. While the regulatory focus remains on the cedent's solvency, a number of specific issues have come to the forefront as the debate has evolved:

Over- Funding of Liabilities: Gross vs. Net

Perhaps the most significant issue for unauthorized reinsurers is that they are obliged to provide funds in trust or to provide other collateral for 100% of their gross liabilities, even if they have significant retrocessional protection. It should also be noted that for assets placed in trust, those trust funds must provide collateral at a level of 102% of the obligations to allow some downward market value flexibility for assets placed in trust.

Pro-Change: Insurers manage their businesses on a net liability basis. That is, they leverage their capital through the use of retrocession and establish their aggregate exposures on a net liability basis. This increases capacity and decreases costs. Current U.S. credit for reinsurance rules, however, require non-U.S. reinsurers to operate in the United States on a gross liability basis; *i.e.*, they are required to post collateral equal to 100% of their gross liabilities to U.S. ceding companies, even though they may have in turn ceded some of these liabilities to other reinsurers. Non-U.S. reinsurers argue that the gross funding requirement compels them to fund the trust from assets properly attributable to other business lines and depletes funds available for non-U.S. beneficiaries. From their perspective, they are paying twice to secure the same liabilities when they purchase retrocessional protection and post collateral out of their own funds.

This 100% collateral requirement is based on 100% of the gross liabilities of the non-U.S. reinsurers due to U.S. cedants with no allowance for any retrocession by the non-U.S. reinsurers. U.S. authorized reinsurers, being regulated in the U.S., are permitted to reduce their gross liabilities by amounts recoverables from their own retrocessions, (provided those retrocessions comply with current rules - *i.e.* are to U.S. authorized reinsurers or to reinsurers that have posted collateral. Under current collateralization rules, non-U.S. reinsurers are not allowed to reduce their gross liabilities by any of their recoverables from any retrocession - even amounts recoverable from U.S. authorized reinsurers and all MBT reinsurers provide Schedule F reports on such retrocessions. However, the vast majority of non-U.S. reinsurers do not file Schedule F reports on their assumed and ceded premiums/losses/reserves by counterparty. U.S. regulators think that this would be a valuable tool in order to track premium and loss flows on a global basis.

Pro-Maintenance: Both U.S. and non-U.S. reinsurers that are unauthorized in a particular state must post collateral for reinsurance liabilities and unauthorized U.S. reinsurers do not receive a reduction for their retrocessional protection either. The amounts that unauthorized reinsurers must post should have no effect whatsoever on a reinsurer's capital since state regulators only require collateralization of amounts that the reinsurer is already *contractually liable to pay* (therefore presumably amounts for which the reinsurer should already have made provision). U.S. statutory accounting rules only require

unauthorized reinsurers to post the same amount of assets in trust as the liabilities they have incurred. As claims are paid and liabilities decrease, the unauthorized reinsurer can reduce the amounts held in trust. The same problems that exist with the collectibility of reinsurance balances also exist for the retrocession protection as well. From the regulatory perspective, the reinsurer can avoid “double funding” by insisting that the retrocessionaire provide its share of the collateral, and if the retrocessionaire is unwilling or unable to do so, that does not justify leaving the liabilities unsecured.

Timing of Funding, Claims Payments and Withdrawals

Another issue concerns the ability for U.S. ceding insurers to access collateral if needed and the inability to pay claims from those trusts. The industry has been discussing a proposal for a “working trust” for some time, which would allow unauthorized reinsurers the ability to actually pay claims directly out of the trust.

Pro-Change: Non-U.S. reinsurers normally post collateral or fund their reinsurance liabilities with financial products that are not used for the payment of claims. For example, certain trust funds are only used for the payment of claims when the reinsurer has not paid a valid claim and the cedent obtains a judgment against the reinsurer, which also remains unpaid. In addition, these trust amounts are only adjusted on a quarterly basis, so if a reinsurer funds 100% of liabilities relating to a catastrophic loss, the reinsurer cannot take money out of the trust until the next quarter. Similarly, letters of credit are usually posted as “stand-by” letters of credit – i.e., they are only to be drawn upon in the event that the reinsurer does not meet its contractual obligations. It should be clearly noted that while a trust may be funded by letters of credit, such letters of credit are not assets of an insurer and are not considered as such pursuant to U.S. statutory accounting principles. This structure affects the pricing and collateral posted for the letter of credit. This “timing” problem was identified as an increasing problem as the trust grew and the claims secured by the trust became more mature (because this resulted in a higher volume of claims being paid out in any one quarter, resulting in a greater “carrying cost.”) This problem is greatly exacerbated by large catastrophic events.

However, there are concerns that it may not be a commercially viable option due to the added costs of administration, and that even if net savings could be realized, they would not be significant unless the working trust were combined with some of the other proposals that have been advanced by unauthorized reinsurers.

The concept of a working trust has been explored in considerable detail. The concept is only relevant to MBT collateral and non-U.S. reinsurers have provided details of their concerns over the administrative costs of replicating their domestic bank accounts, which would be onerous (especially across a London co-subscription market). They also mention concerns over the administrative burden regulators would face with checking the reconciliation of daily claims movements against established claim-by-claim reserves. Finally, they point out that the working trust proposal does not address the key concern that collateral must be sustained at gross reserve levels on a quarterly basis.

The process to pay a valid Lloyd’s claim to the policyholder is straightforward. Once the claim has been agreed by the contracting parties or by an arbitration award or final court judgment, the claim is paid in the normal course from the Lloyd’s Dollar Trust Funds (‘LDTFs’) in London. These are the ‘working funds’ utilized by Lloyd’s as part of its daily central accounting procedures and used for the receipt of

premium, purchase of outward reinsurance, expenses etc., as well as the payment of valid claims on U.S. dollar business.

Only in the event there are inadequate funds in the underwriting member's LDTF, would Lloyd's seek to access an underwriting member's Lloyd's reserves (known as "Funds at Lloyd's") to replenish the LDTFs. It is only after these reserves are totally exhausted, that a claim would be made by the managing agent on the Lloyd's Central Fund.

The process described here is seamless from a policyholder's point of view and a valid claim would still be paid in the normal way, without delay. It would be the Lloyd's managing agent who would take care of any funding shortfall and take steps to obtain further funds from the underwriting member or ultimately, make a claim for a drawdown from the Lloyd's Central Fund. Overdraft facilities are established as part of Lloyd's central accounting procedures to enable Lloyd's underwriting members to meet their daily obligations to settle claims. A policyholder, therefore, never has to try to "collect from Names and the Central Fund" as part of the usual Lloyd's claims process.

It will also never be necessary to access Lloyd's MBTs, so long as the LDTFs continue to be utilized by Lloyd's to meet claims obligations as they fall due and are replenished as required either from the underwriting member's Lloyd's reserves or other funds and ultimately from the Central Fund.

To date, there have been no cases where it has been necessary to execute a judgment to obtain funds from Lloyd's MBTs.

If it were to be necessary to execute a drawdown from Lloyd's MBTs, then it is Lloyd's expectation that the process would be straightforward. The claimant would simply present his final judgment to the U.S. trustee bank of the MBTs and after 30 days the claim would be paid to the policyholder.

The provisions in Lloyd's MBTs reflect the requirements contained in the Credit for Reinsurance Model Law. In addition, Lloyd's complies with all the provisions and reporting requirements mandated by the New York Insurance Department, Lloyd's domiciliary regulator. The MBTs are audited annually, are subject to actuarial review and are maintained at the level required to meet outstanding liabilities as determined each quarter.

Pro-Maintenance: Regulators and authorized reinsurers express no objection in principle to the "working trust" concept as long as the trust remains adequately funded at all times.

International Harmonization of Reinsurance Supervision – Mutual Recognition

In order to facilitate cross-border reinsurance, there is a desire to establish an effective, international supervisory framework that would allow (host) supervisors to mutually recognize the quality of the regulation and supervision exercised by supervisors in another (home) jurisdiction, and thus possibly remove or alleviate additional regulatory and supervisory requirements for reinsurers in that host jurisdiction. The eventual goal of this process would be to identify the (minimum) principles for the essential coordination of reinsurance regulation and supervision in a jurisdiction sufficient to allow mutual recognition and thereby further strengthen cooperation and trust between reinsurance supervisors, both on a bi-lateral and a multi-lateral basis.

An example of such a system is the “single market” in the EU, which provides a system for the authorization and financial supervision of an insurance (or composite insurance/reinsurance) undertaking by the Member State in which it has its head office ('home country control'). The recently approved EU Reinsurance Directive extends this concept to professional reinsurers and such authorization would be for reinsurance companies, exactly as it is for direct insurers, a true “single passport” which would enable them to carry on their business anywhere in the European Union. The proposal also sets out prudential rules for the supervision of reinsurance undertakings. Historically, the supervision of reinsurance varied considerably within the EU and passage of this directive will improve the consistency with which minimum regulatory standards are enacted and applied by insurance supervisors among the EU countries. The passage of the EU reinsurance directive also fills an important gap in the EU's creation of a single market for financial services. The members' enactment of the directive into national law will provide an important step in gaining experience on application of the new rules, especially in those countries that heretofore have not supervised reinsurance.

Pro-Change: Beside the U.S., Canada, France, Germany (Life Insurance Only) and Portugal are the only known countries that have collateral requirements. (France and Portugal will be eliminating theirs by October 2008 due to the passage of the EU Reinsurance Directive). The United Kingdom, Germany (Non-life), Switzerland, Bermuda and Japan are among the major reinsurance jurisdictions in the world that do not have collateral requirements and do not have major problems with uncollectible reinsurance. The U.S. should consider the experience of these markets. It is likely that a common international approach will emerge in the setting of appropriate standards for reinsurance cessions. The U.S. credit for reinsurance regime is constrained in its focus and impact. The current U.S. credit for reinsurance requirements discriminate against EU reinsurers particularly in cases where reinsurance protection is placed with reinsurers subject to a proper system of supervision. International comity calls for granting mutual recognition to other jurisdictions that implement and maintain effective regulatory systems based on the evolving international consensus. Granting mutual recognition to those jurisdictions whose regulatory frameworks are as secure and strong as that maintained in the U.S. will not result in lowering U.S. standards.

U.S. reinsurers have criticized the EU Reinsurance Directive as inadequate, but their criticism ignores the fact that the Directive needs to be read in conjunction with other EU Directives that govern accounting rules and other supervisory requirements to which insurers and reinsurers in the EU are subject. In addition, they ignore the fact that certain EU regulators (e.g. the UK) have elected to augment and develop their solvency and supervisory regimes to even more exacting standards than current EU Model Directives.

This mode of trading is recognised in international terminology as “cross-border” trading. It is an important feature of the international reinsurance market and U.S. domiciled reinsurers also operate on this basis around the world. Most developed countries do not presently place restrictions on cross border trade. In fact, U.S. reinsurers are permitted to write reinsurance of European cedants on a cross border basis (i.e. operating from bases in the U.S.) without any regulatory restrictions or collateral (except in France and Portugal, which will be phased out under the recently adopted EU Reinsurance Directive.) If they wish to establish a base in the EU, then they may set up a subsidiary or branch in one member state. Under the Insurance Directives, U.S. Composite insurers/reinsurers are already permitted to trade in all EU countries on the basis of a home state licence. Professional reinsurers will also be

permitted to trade across the EU on the basis of a home state licence, once the EU Reinsurance Directive is implemented.

Pro-Maintenance: While everyone agrees mutual recognition is a worthy long-term goal, it is premature to adopt now, especially with the considerable disparities that remain between the accounting principles in different countries. For example, it is commendable that the EU has passed the EU Reinsurance Directive and that there will be some minimum level of harmonized regulation of reinsurers within the EU. The Directive allows the member state to strengthen the minimum level of regulatory requirements. It is far too early to tell how the EU Reinsurance Directive will be implemented in practice among the various jurisdictions, and there are many solvency measures evident in U.S. reinsurance regulations that appear to be lacking in the minimum regulatory requirements in the EU Reinsurance Directive: limitations on risk exposures [10% of surplus], audited financial statements, certified actuarial opinions concerning adequacy of reserves, disclosure of material transactions, no risk based capital approach to solvency, etc.

Collateral has proven to be an effective solvency measure protecting U.S. ceding entities and ultimately policyholders of U.S. insurers. If U.S. regulators determine, at some point, that mutual recognition of a particular nation's law is appropriate, the regulatory standards imposed on U.S. reinsurers must be no greater than those of the nations being recognized. However, before U.S. regulators can responsibly consider mutual recognition for non-U.S. reinsurers, there must be significantly greater transparency of non-U.S. accounting practices and regulatory systems than currently exists. In addition, mutual recognition should exist between U.S. states before any such recognition be given to non-U.S. entities.

Investment Criteria and Strategy

U.S. regulatory rules place particularly conservative investment requirements for those funds being held in the U.S. Non-U.S. companies have argued that these restrictions have impeded investment income and interfered with corporate risk management objectives.

Pro-Change: The major reinsurers who support the U.S. insurance market operate on a truly global basis. They have wide-ranging and sophisticated investment strategies. These investments will include both U.S. dollar denominated and non-U.S. dollar denominated investments, which are part of investment programs that balance return and security in relation to the reinsurer's global operations.

At the same time, the eligible asset requirements of U.S. trusts and the banks' collateral requirements for letters of credit are much more restrictive than the investment guidelines used by international reinsurers (this is true even in light of the decision made several years ago to allow certain trusts to have up to 20% of their assets in qualifying foreign investments).

To require reinsurers immediately to fund 100% of their gross liabilities for losses and simultaneously to liquidate assets to begin to pay claims that are being settled, or will be settled within the next several months, will force reinsurers to dramatically shift their investment portfolios toward short-term, highly liquid, U.S. dollar-denominated assets. This will unnecessarily reduce investment returns for reinsurers.

Pro-Maintenance: From a prudential solvency perspective, U.S. state insurance regulations do require limitations on the investments that can be held to collateralize U.S. reinsurance liabilities. Non-U.S.

reinsurers typically hold larger amounts of investments in equity positions than U.S. reinsurers are permitted to hold. In times of declining equity markets (*e.g.*, 2000-2002), however, regulatory investment limitations helped non-U.S. reinsurers avoid even larger equity losses and increased threat of insolvency.

Unnecessary Transaction Costs

Unauthorized reinsurers that maintain LOCs are charged a fee from the banks that are holding those funds. It is estimated that these costs amount to approximately \$200-500 million per year, which results in inefficiencies in the marketplace and increases reinsurance costs for U.S. insurers and policyholders.

Pro-Change: The security and collateral requirements of the various funding mechanisms used by unauthorized reinsurers have transaction costs. Bank fees for LOCs are the most significant at 40-60 basis points, but MBT reinsurers also estimate their costs at 15-45 basis points. These costs do not include the costs of maintaining inefficient levels of gross reserves in static deposits, this depleting the reinsurers capital and surplus and liquid funds available to meet policyholders claims promptly. Lloyd's estimates their total costs at \$ 150 million in complying with the various trust fund requirements. In addition to the costs, there is also a question concerning the availability of LOCs to support the reinsurance liabilities arising out of significant catastrophic losses. The benefits for U.S. ceding insurers are in creating a more efficient regulatory regime for the U.S. reinsurance market. Efficient operation of an industry is obviously beneficial to customers and providers of services. Decreasing transaction costs and eliminating unnecessary regulatory burdens can only have a positive impact on the U.S. reinsurance market. It is clear that collateral costs are significant. As with all costs associated with the delivery of a goal or service, the customers ultimately pay the costs involved.

Pro-Maintenance: Costs associated with maintaining LOC's for the benefit of the cedent average between 40–60 basis points depending on the credit worthiness of the company. This is an increase from years ago where the cost was about 25 bps. Many counter parties have moved to other forms of collateral such as trust funds, where the cost is much less (15 bps, for example), or to funds held accounts where there is little cost to either party such as additional internal accounting with respect to the fund balance.

There is no doubt that there are costs involved with maintaining LOC's and trust funds and while the actual is funded by the reinsurer, it is built into the price paid by the buyer for reinsurance coverage. Many U.S. ceding insurers view these balances as a small price to pay for the added security provided by collateral, whatever form it takes. If collateral requirements were reduced for qualified professional reinsurers, what would these reinsurers do with those funds earmarked to pay claims of U.S. policyholders? One likely scenario of concern to regulators is that the reinsurers would leverage those funds in writing additional business globally, thus putting at risk precisely those monies ultimately owed to U.S. policyholders.

A request was made to determine the amount of capacity that would be generated by reducing collateral. The U.S. industry indicated that the total amount of collateral posted by unauthorized reinsurers (Sch. F Part 5, Col 7 plus Col 10) and added to the Lloyd's trust funds (as reported in the NAIC's 2003 Lloyd's Review) determined the total amount of collateral maintained. Transaction costs of 1% (collateral reduction proponents have stated the costs are between .5% and 1%) were assumed.

This shows about \$1B in costs, which was grossed-up by a factor of 2 to reflect additional premium capacity at 200% of surplus. (Actually U.S. reinsurers are writing at 74% NPW to PHS [excluding National Indemnity]) \$2B of additional capacity equates to an increase of about 1.3% globally and is only an increase of 3.8% above the capacity that is currently being provided by unauthorized reinsurers in the U.S. Even these numbers overstate the likely amount of additional capacity because they assume the following:

- 1) Complete elimination of collateral
- 2) All additional capital will support new U.S. capacity
- 3) Reinsurers will write at a 2:1 NPW to PHS ratio.
4. Collateral costs average 1% (on the high end of the spectrum)

Analysis of Maximum Additional Capacity Given the Elimination of U.S. Collateral Requirements	
Data in Thousands	
2004 U.S. Collateral posted by Lloyd's and Unauthorized Reinsurers	106,163,369
Multiplied by Yearly Collateral Transaction Costs	1%
Cost of Maintaining Collateral in the U.S.	1,061,634
Cost of Maintaining Collateral in the U.S.	1,061,634
Multiplied by Ratio of Premium to Capital 2:1	2
Maximum Additional Capacity (if collateral requirements are eliminated)	2,123,268
2004 U.S. Premiums Assumed by Lloyd's and Unauthorized Reinsurers	55,177,213
2004 Global Reinsurance Premium Written (S&P Global Reinsurance Highlights)	166,899,200
Max Additional Capital as a % of 2004 U.S. Prem Assumed by Lloyd's and Unauth Reinsurers	3.8%
Max Additional Capital as a % of 2004 Global Reinsurance Premium	1.3%

Assumptions used to calculate the maximum additional capacity:

1. complete elimination of collateral requirements
2. reinsurers will write at a 2:1 premium to capital ratio
3. all additional capacity will be used to write additional business in the U.S.
4. collateral transactions costs at 1% (the actual range is between .5% and 1%)

U.S. P&C Industry Aggregate**
Net Reinsurance Recoverable and Collateral Offsets
2004 Statutory Data in Thousands

	Collateral Offsets				
	Net Recoverable	Funds Held	Letters of Credit	Trust Funds (Other)	Total Collateral
Authorized Affiliated	10,920,845	717,801	0	0	717,801
Authorized Unaffiliated	139,816,981	6,770,616	0	16,163,000*	22,933,616
Authorized Total	150,737,826	7,488,417	0	16,163,000*	23,651,417

	Collateral Offsets				
	Net Recoverable	Funds Held	Letters of Credit	Trust Funds (Other)	Total Collateral
Unauthorized Affiliated	47,147,591	11,301,269	16,599,577	25,796,705	53,699,551
Unauthorized Unaffiliated	42,881,877	11,520,688	23,718,636	23,883,451	59,122,775
Unauthorized Total	90,029,768	22,821,957	40,318,213	49,682,156	112,822,326
Grand Total	240,767,594	30,310,374	40,318,213	65,845,156	136,473,743

Source: Highline Data--OneSource Database

*Note: Lloyd's U.S. MBT amount as reported in the NAIC's 2003 Lloyd's Review. This analysis does not include voluntary LOC and trust fund collateral posted by authorized reinsurers.

**Note: 2004 industry aggregate totals (as calculated by Highline Data) have been adjusted by the RAA to incorporate AIG group results net of intercompany transactions. This is necessary because AIG has not yet submitted combined filing data to the NAIC for 2004.

Net Recoverable: equals total recoverables less reinsurance payables.

U.S. P&C Industry Aggregate
Net Reinsurance Recoverable and Collateral Offsets
2003 Statutory Data in Thousands

	Collateral Offsets				
	Net Recoverable	Funds Held	Letters of Credit	Trust Funds (Other)	Total Collateral
Authorized Affiliated	15,464,396	2,009,998	0	0	2,009,998
Authorized Unaffiliated	138,990,753	7,073,211	0	16,163,000*	23,236,211
Authorized Total	154,455,149	9,083,209	0	16,163,000*	25,246,209

	Collateral Offsets				
	Net Recoverable	Funds Held	Letters of Credit	Trust Funds (Other)	Total Collateral
Unauthorized Affiliated	41,377,957	9,381,339	13,911,994	20,773,652	44,066,985
Unauthorized Unaffiliated	43,891,236	13,685,290	24,266,876	15,435,230	53,387,396
Unauthorized Total	85,269,193	23,066,629	38,178,870	36,208,882	97,454,381
Grand Total	239,724,342	32,149,838	38,178,870	52,371,882	122,700,590

Source: Highline Data--OneSource Database

*Note: Lloyd's U.S. MBT amount as reported in the NAIC's 2003 Lloyd's Review. This analysis does not include voluntary LOC and trust fund collateral posted by authorized reinsurers.

Net Recoverable: equals total recoverables less reinsurance payables.

Counterparty Credit Risk – Inconsistent with other Solvency Rules

Collateral stands as a proxy for direct regulation since unauthorized reinsurers do have the options of becoming licensed, forming a branch, becoming accredited or forming a subsidiary operation in the United States. Many Non-U.S. reinsurers have chosen one or more of these options. However, due to its unique structure these options are not available to Lloyds.

Pro-Change: Reinsurance is essentially a counterparty credit risk. U.S. solvency rules accept many other forms of counterparty credit risk without collateral; *e.g.*, corporate bonds (even bonds issued by non-U.S. corporations), agents' balances in the course of collection, etc. The current credit for reinsurance rules are inconsistent with these rules. This inconsistency is most dramatically demonstrated by the fact that a ceding insurer can purchase a corporate bond from one of the leading non-U.S. reinsurers and count this bond as an asset on its balance sheet without collateral, whereas a reinsurance recoverable from that same reinsurer is not allowed as an asset or deduction from liabilities without 100% collateral. Current rules also discourage U.S. insurers from making effective and prudent decisions in their choice of reinsurer, based on the strength of the reinsurer. Ceding insurers could be tempted to ignore the underlying strength of a reinsurer because it makes no difference to the balance sheet credit a primary company receives from it. As a result this could divert more business to weaker companies, and this does not support the prudential goals of U.S. regulators.

This fact has been why some have argued that the current rules on collateral should be revised and extended to apply to all reinsurers (including those in the U.S.) in a system based on assessment at the strength of the reinsurer.

Pro-Maintenance: Reinsurance is absolutely a counterparty credit risk and one that has a potentially significant solvency risk especially for those insurers/reinsurers that have significant reinsurance recoverables and concentration of risk to certain reinsurers. The argument that U.S. insurers can hold corporate bonds of non-U.S. entities does not address the fact that there is no secondary market to price or value reinsurance recoverables whereas there is such a mechanism for corporate bonds. Reinsurance is fundamentally different from other assets, because the reinsurer's commitment is often largely open-ended, and because reinsurance is given special accounting treatment, netted out dollar for dollar against reserves on an undiscounted basis, on the theory that it reduces or eliminates the uncertainty of the cedent's primary losses.

U.S. primary insurers support retention of collateral requirements. To U.S. primary insurers, who are the consumers of reinsurance, the collateral requirement is neither a trade issue nor a level playing field issue, but serves as a critical solvency protection issue. From the U.S. primary insurer view, collateral helps ensure that obligations due U.S. insurers from unauthorized reinsurers are paid in full in a prompt manner. U.S. primary insurers believe any reduction or elimination of the collateral requirement would threaten U.S. insurer and state receiver recoveries from unauthorized reinsurers at a time when solvency protection should be a paramount concern.

International Accounting Standards (See Appendix II, III, IV for more detailed discussion of the various regulatory and accounting regimes)

The differences between the Generally Accepted Accounting Principles (GAAP) and statutory accounting principles (SAP) approaches to measuring the potential uncollectibility of reinsurance recoverables reflect the underlying philosophies of these accounting systems.

The objectives of GAAP reporting differ from the objectives of SAP. GAAP is designed to meet the varying needs of the different users of financial statements. SAP is designed to address the concerns of regulators, who are the primary users of statutory financial statements. As a result, GAAP stresses measurement of emerging earnings of a business from period to period, (*i.e.*, matching revenue to

expense), while SAP stresses measurement of ability to pay claims in the future. This difference is best illustrated by reviewing the treatment of acquisition costs under GAAP and SAP. Under GAAP, acquisition costs are capitalized and released to earnings as the profits from the underlying insurance policies emerge (matching concept). Under SAP, such costs are expenses as incurred because a deferred asset is not available to satisfy policyholder obligations. In addition, for life insurance products, SAP mandated the use of conservative assumptions whereas under GAAP management establishes those assumptions. Therefore, life reserves are often higher under SAP than GAAP. This is not the case for property and casualty (P&C) reserves as both GAAP and SAP require those amounts to be established at management's best estimate. Consequently, P&C reserves are often equal under GAAP and SAP.

The chart below summarizes the differing objectives of GAAP and statutory accounting.

	<i>GAAP</i>	<i>Statutory Accounting</i>
Audience Served	investors	policyholders
Focus (Topic)	profitability	solvency
Focus (Financial Statement)	income statement	balance sheet
Nature of Estimate for Life Reserves	unbiased	conservative
Basis of Estimate for Life Reserves	company management	statutory formula
Users	public	regulators
Companies Targeted	going concern companies	distressed companies

Pro-Change:

It should be noted that whilst the above commentary has been drafted from the perspective of U.S. regulators, regulators in other key jurisdictions are also aware of and impose rules to ensure regulatory returns provide adequate information to serve their prudential objectives. In the UK, for example, the FSA requires regulatory returns to be prepared under the FSA. They require regulatory returns to be prepared under UK GAAP or IAS but they impose various additional rules that adjust the valuation and/or admissibility of certain assets. For example, intangibles are not admissible assets for the purpose of the FSA regulatory returns. There are also prescribed limits in relation to admitted assets for counter party and market risks.

U.S. regulators understand or should be able to gain an understanding of financial statements prepared by reinsurers domiciled in most, if not all of the countries in which the world's leading reinsurers are domiciled. This is particularly true for reinsurers who maintain their accounts pursuant to U.S. or UK GAAP rules or who use International Accounting Standards. Virtually all of the world's major reinsurers use one of these accounting rules. U.S. regulators accept as admitted assets securities of foreign insurers, the financial statements for which are prepared in accordance with a wide variety of accounting standards. As regulators accept as admitted assets securities of foreign insurers, the financial statements for which are prepared in accordance with a wide variety of accounting standards, it follows that they should be able to understand these statements. Non-U.S. reinsurers do not agree that the differences between international accounting systems are "discrepancies". The differences can be easily identified and any adjustments made as necessary. Any so called lack of transparency can be resolved by identifying the actual differences and making any relevant adjustments as appropriate, between IAS and SAP. Whilst some of the profitability, leverage and operating ratios of certain non-U.S. entities

would be worse presented under U.S. SAP, it does not necessarily follow that these entities are potentially distressed or expiring companies, and adjustments can be made to allow for the comparison. U.S. regulators are also free to require additional data/reporting from non-U.S. reinsurers to supplement UK GAAP/IAS reports and provide the additional prudential measures they require.

Pro-Maintenance: There is U.S. industry opposition to any changes to the current regulatory system until such time as discrepancies between international accounting systems are remedied. There is a lack of transparency between proposed “international GAAP” and U.S. SAP system required of the domestic insurance industry.

Since SAP are usually more conservative than GAAP accounting guidance, profitability, leverage and operating ratios of non-U.S. entities would likely be worse if those non-U.S. entities had to report their financial results on the same basis as every U.S. insurer.

Maintenance of Funds within the United States

One of the central purposes of the collateral requirements for unauthorized reinsurers is to guarantee not only that the funds exist to back the reinsurance recoverables but that they are under the effective control of the cedent and under the oversight of the cedent’s regulator.

Pro-Change: The requirement to tie up dedicated funds reserved to a burdensome “gross liabilities” standard in a single jurisdiction, rather than allocate them where they are most needed, is inefficient, costly, and gives an unfair preference to some customers at the expense of others. Collateral should a) be provided based on a regulatory requirement arising from a proper assessment of individual reinsurer financial strength/weakness or b) based on a commercial contractual agreement between the counter parties. Nothing in proposals made by non-U.S. reinsurers has ever suggested that collateral could not be negotiated as a commercial condition of the reinsurance contract, nor as a measure imposed by regulators on a weak reinsurer.

Pro-Maintenance: The purpose of the collateral requirements is not simply to have assets within the United States, but to have them where they are accessible to the ceding company and to regulators if there is a dispute or if the reinsurer is simply unwilling or unable to pay. As discussed earlier, the collection of reinsurance recoverables often becomes difficult when the relationship between the parties breaks down, and especially when either the reinsurer or the cedent is in financial difficulty. These problems are greatly aggravated if the assets are overseas, and must be pursued under a foreign legal system, where a variety of factors may make it difficult, costly, and time-consuming for a foreign litigant to pursue, obtain, and collect a judgment.

Enforceability of U.S. Judgments Abroad

A frequently cited obstacle to the collectibility of reinsurance recoverables, in the absence of U.S. collateral, is concern over the need to sue in the reinsurer’s home country if there is a dispute. There may be uncertainty in the foreign enforcement of U.S. awards, particularly if public policy exceptions to enforceability, default judgments, or punitive damages are involved. The International Bar Association (IBA) commented on the four; due process, public policy, insolvency and default issues, described below that have been raised in respect of the new Hague Choice of Court Agreements Convention. IBA

was a delegate to The Hague who, along with the International Association of Insurance Supervisors (represented by Commissioner Oxendine), was responsible for securing coverage of the Convention for insurance and reinsurance agreements. In sum, IBA believes that the four issues are resolved by the express provisions and declared intent of the Convention. IBA notes that the due process and public policy issues are inter-related and conform to the U.S. constitutional concepts of procedural due process in order to ensure that judgments are fairly entered against defendants who have been duly and properly served with process. IBA cites U.S. federal bankruptcy and other U.S. ratified treaty provisions incorporating similar due process and public policy protections, and notes that the protections apply to all persons and entities, U.S. and non-U.S. alike. With respect to insolvency, IBA explains that a judgment entered in a proceeding involving an insurer in receivership would not be accepted from the Convention, as long as the object of the judgment was not to challenge the insurer's insolvency or the receivership statute. On the issue of default judgments, IBA points to provisions within the Convention which show that it specifically applies to default judgments and that only the facts supporting the exercise of jurisdiction could be reviewed on a petition for recognition and enforcement, not the merits or amount of the judgment. IBA notes that the industry representatives who raised the issues - along with this Task Force and the NAIC - supported the fruitful efforts of IBA and IAIS. IBA requests that such support continue as the Convention comes on for ratification in the U.S. and elsewhere within this next year.

Pro-Change: Although much has been said on the issue of enforcement of judgments (should not be an issue of contention), unauthorized insurers assert that the fact remains that there is no evidence of a real problem with enforcing valid U.S. judgments against non-U.S. reinsurers. Moreover, opinions of counsel in a number of important jurisdictions, and letters from the governments of the United Kingdom, France and Germany, indicate that this should not be a problem. In this regard, it is worth noting that currently E.U./U.S. cross-border trade is approximately \$1 billion a day. This level of trade is only possible because of a mutual recognition of each other's laws. This same legal framework will support E.U./U.S. reinsurance transactions. Finally, if an approved list of reinsurers were established, a country-by-country review of enforcement of judgment laws would be conducted as part of the listing requirements.

Substantial research to date – including letters from the governments of England, France and Germany – indicates that there is not a problem in these jurisdictions. To date, there has not been credible case law presented which demonstrates that there is, in fact, a problem with the enforcement of U.S. judgments in the major reinsurance capitals of the world. If a particular jurisdiction proves to be problematic, then reinsurers domiciled in such jurisdictions should be entitled to reduce collateral requirements.

Virtually all insurance contracts include an arbitration clause, which is governed by the New York Convention on enforcement of arbitral awards to which a large number of Governments, including the U.S. are already party.

It is true that no reciprocal enforcement treaty operates between the U.S. and other countries but this is not really significant given the ease with which the Common Law in the key European Countries mentioned will allow recognition of U.S. Judgments (although clearly the position will be simplified further if the Hague convention comes into force and the U.S. and England sign up to it.) The existence or otherwise of an enforcement treaty is even more irrelevant in the case of reinsurance contracts, because virtually all reinsurance contracts have arbitration clauses. In addition U.S. regulators

had the foresight many years ago to impose rules to ensure that service of process must be provided for in a U.S. jurisdiction. This means that any concerns as to difficulties with service of process in Switzerland are just not relevant to the enforcement of a claim under a U.S. reinsurance contract.

Finally, specific provisions for the preferred jurisdiction and law can always be provided in reinsurance agreements, and regulators could mandate those.

U.S. Arbitral Awards are readily enforceable in England, as if they were judgments of the English Court pursuant to the Arbitration Act 1996 and the New York Convention on the Recognition and Enforcement of Foreign Arbitration Awards 1958.

In the rare cases, where there is no arbitration award, but remedy is pursued in the U.S. courts, then the procedure for obtaining recognition of a U.S. Judgment in England is straightforward. It merely involves bringing a common law claim for breach of contract, a claim which would likely be suitable for Summary Judgment. Default Judgments are no different to contested ones.

The exceptions to recognition will rarely be relevant in a reinsurance context. The laws of most countries (including the U.S. States when recognizing judgments from one state to another) reserve the right to make an exception for reasons of “due process” or “public policy”.

Natural justice/due process – broadly the process requirements of U.S. law are similar to English law e.g. notice of claim, right to be heard and represented, etc., so a U.S. judgment on a reinsurance agreement is unlikely to fall foul of natural justice/due process requirements.

Public policy - as regards damages, punitive or exemplary damages are not contrary to English law/public policy and can be enforced (SA Consortium General Textiles case). (But the multiple damages element of judgments/awards will not be enforced – Protection Trading Interests Act 1980, the Laker and Eliades cases, the latter holding that the multiple damages award is severable from the rest of the judgment so that part of the judgment can be enforceable.)

It is important to note that despite possible and rare examples of non-enforcement of multiple damages, these cases are not relevant to the enforcement of a reinsurance claim. Under English law, a reinsurance claim would be treated as a simple debt and enforced accordingly. Therefore, if the underlying claim included punitive or multiple damages, would be enforced as part of the debt. The court would not look into the components of the claims award. The amendments to the Draft Hague Convention merely clarify what is already the position under English Common law and was implicit in the original text of the convention.

Pro-Maintenance: The U.S. State Department has confirmed that there are problems with enforcing U.S. judgments in foreign jurisdictions as “the law and practice in most foreign countries is not generally favorable to the prompt, predictable enforcement of U.S. civil judgments.” The U.S. insurance industry also has previously provided the NAIC with a paper setting forth examples of the problems that U.S. insurance entities have encountered as a result of difficulties with enforcing U.S. judgments in foreign jurisdictions, including comments by U.S. regulators and relevant case law. There is no international counterpart to the “full faith and credit” clause of the U.S. Constitution, which requires U.S. states to honor each other’s judgments. Although many efforts have been made over the years to negotiate more

comprehensive international treaties for mutual recognition of judgments, significant differences between legal systems have caused negotiators to narrow their focus. Nevertheless, despite its limited scope, a recently negotiated treaty represents a significant step forward, since if it is implemented, it will allow the parties to control the forum in which contractual disputes are resolved.

On June 30, 2005 negotiations were completed and the Hague Conference on Private International Law adopted the Hague Convention on Choice of Court Agreements. The Convention now awaits ratification. The Convention offers provisions giving effect to choice of court agreements in international commercial cases where the parties agreed to an exclusive choice of court for resolving their disputes and provisions requiring the courts of participating countries to recognize and enforce judgments under such agreements (excluding consumer and personal matters and a short list of additional exclusions.) Thus, if the United States becomes a party, and a reinsurance contract designates a U.S. forum as required by U.S. credit for reinsurance laws, a U.S. judgment against the reinsurer must be honored if a collection action is brought in the reinsurer's home country, that country is also a party to the Hague Convention, and no exception applies. Despite the fact that the Convention will not address all of the U.S. industry's concerns regarding the enforceability of judgments, we strongly encourage ratification of the Convention and urge continued efforts to resolve the remaining issues.

Insurance and reinsurance contracts are specifically addressed in the text of the Convention, which provides that such contracts are not excluded from the scope of the Convention even if they relate to a matter to which the Convention otherwise does not apply. Further, judgments in respect to liability under insurance and reinsurance contracts that include non-compensatory damages that might otherwise be refused under the Convention shall not be limited or refused.

What are the Convention's limitations?

- **Exceptions:** The Convention does not prevent a court from refusing to enforce a judgment upon finding any of a number of exceptions, including the following:
 - (1) **Due Process Exception:** If the defendant was not notified of the original court proceeding in accordance with the fundamental principles of due process of the foreign state. This is of particular concern with civil law countries. Thus, if a Swiss defendant is sued in the U.S. and is not served notice in accordance with official notice requirements in Switzerland the resulting judgment could be refused enforcement in Switzerland.
 - (2) **Public Policy Exception:** If enforcement would be manifestly incompatible with the public policy of the foreign country. For example, industry analysis of case law indicates that U.S. state insurance code requirements such as pre-answer security could render a judgment unenforceable under public policy exceptions in British Common Law and Swiss Law.
- **Declarations with respect to specific matters:** The Convention allows jurisdictions to declare that certain matters are not subject to the Convention as adopted in that jurisdiction. Matters dealing with asbestos, natural resources, and joint ventures have been of noted concern among particular countries during negotiation of the Convention. The language of the Convention addressing insurance does not provide a specific exception to the declaration provisions so the

declaration provisions will likely take precedent over the insurance provisions and will allow a country to refuse enforcement of insurance and reinsurance obligations related to such matters.

- **State Insurance Receivers:** The Convention may not provide a means for state insurance receivers to enforce judgments under state receivership authority. The Convention relates to private international law only and not public law matters. Furthermore, the Convention does not apply to insolvencies or analogous matters, although determination of liability under a contract even though a party is insolvent will fall within the scope of the Convention. The drafters note that government officials may utilize the Convention to the extent that they are a party to a commercial contract, but they may not use it to exercise powers that a private person could not exercise.

Pending Issues

- **Default Judgments:** The Convention only applies to judgments decided “on the merits” of the case, thus we might expect that default judgments would not be enforceable under the Convention. However, there are references to default judgments in the Convention that conflict with that interpretation. Conversations with the State Department confirm that the drafters of the Convention intended that it would apply to default judgments. We are told that the reference to decisions on the merits was intended to distinguish between final judgments as opposed to interim judgments. In response to our inquiry, the State Department representative said that they will request that the final Report of the Convention clarify this intention so as to inform courts as they interpret the language of the document.

Collateral as a Trade Issue

Non-U.S. reinsurers and regulators have stated that U.S. reinsurance collateral requirements represent an unfair regulatory barrier to trade. Following emergence in 1997 of a World Trade Organization (WTO) regime for liberalizing trade in financial services, including insurance and reinsurance,²¹ the question was posed whether the U.S. collateralization requirement raised an international trade issue. An international insurance industry white paper was issued in October 2001 by the Financial Leaders Working Group on Insurance, the Proposed Model Schedule for Future Insurance Commitments by WTO Members (the Model Structure)²², urging all governments to move toward the freest possible movement of international reinsurance, including the elimination of discriminatory requirements for collateralization and localization of assets. The U.S. international insurance and reinsurance industry supported the Model Schedule initiative.

Pro-Change: Some have argued that collateral requirements should not be reduced because non-U.S. reinsurers have been, according to their calculations, gaining market share. Non-U.S. Reinsurers dispute

²¹ International insurance and reinsurance trade were placed under the General Agreement on Trade in Services (GATS) Financial Services Annex, which seeks liberal treatment of international insurance and reinsurance trade, in December 1997.

²² The Model Schedule was jointly drafted and endorsed by the leading insurance/ reinsurance industry trade associations in Canada, the European Union, Japan, and the United States. The U.S. parties to the Model Schedule are The American Insurance Association, the American Council of Life Insurers, the Council of Insurance Agents and Brokers, and the Reinsurance Association of America.

these calculations of market share and suggest that care be taken in understanding their presentation. They estimate that non-U.S. reinsurers write a maximum of 35% of the U.S. reinsurance market. Credit for reinsurance rules are to be a tool of solvency regulation, not a tool for market allocation. Protecting market share by imposing unnecessary regulatory burdens violates U.S. trade agreements and harms consumers who ultimately pay the price for excessive collateral requirements. Today U.S. credit for reinsurance rules do not distinguish between financially strong, well-regulated reinsurers and more marginal reinsurers. They treat a BB– rated reinsurer domiciled in an offshore jurisdiction the same as an AA rated reinsurer domiciled in a major European financial capital. They both must fund 100% of their liabilities. Equally, the current rules treat any reinsurer with a U.S. license as a good credit risk. The number of insolvencies of U.S. insurers demonstrates this is not a valid assumption. A reinsurer licensed in another state may apply to be an "accredited reinsurer" on the strength of its domiciliary license. A non-U.S. reinsurer does not have this option.

U.S. Reinsurers state that U.S. licensed insurers have posted over \$6bn in collateral on U.S. reinsurance business. This compares to \$127.4bn of total collateral and \$240bn of total recoverables. (See earlier in this paper.) Lloyd's underwriters and Hannover Re alone hold collateral in the U.S. that totals over \$9bn. This figure demonstrates how few U.S. unauthorized reinsurers there are. In addition, U.S. Reinsurers collateral is not necessarily all provided by unauthorized U.S. reinsurers and therefore is not necessarily all funded based on gross reserves.

Large global players have strong commercial reasons for maintaining a presence in the United States *i.e.*, local access to clients/producers.

Many of the largest non-U.S. reinsurers do already have U.S. licensed subsidiaries. The global nature of the reinsurance market means, however, that a substantial amount of U.S. business is placed outside of the U.S. This is an essential aspect of spreading risks around various capital markets. Many non-U.S. reinsurers are based in international markets and complex distribution dynamics means business flows on a cross border basis to those centers that would not be available from a U.S. established base. Furthermore, U.S. reinsurers also transact business around the world on a cross-border basis without equivalent restrictions. Accordingly, the U.S. needs to have reasonable rules for cross-border reinsurance, and to encourage modern, strong, prudential standards as a precedent and sound role model for other developing regimes.

Pro-Maintenance: Collateral requirements are a part of the NAIC's solvency regulation standards program. They are a fundamental part of state based solvency regulation and as such they fall under the "prudential" exception in the international trade rules. The U.S. stakeholders' view is that the U.S. credit for reinsurance system is not discriminatory because it provides options that are available to both U.S. and non-U.S. entities.

The WTO does not have jurisdiction over state regulatory authorities, nor does the WTO tell governments how to conduct their trade policies. The rules of the WTO system are agreements resulting from negotiations among member governments, the rules are ratified by members' parliaments, and decisions taken in the WTO are virtually all made by consensus among all members.

The only occasion when a WTO body can have a direct impact on a government's policies is when a dispute is brought to the WTO and if that leads to a ruling by the Dispute Settlement Body (which

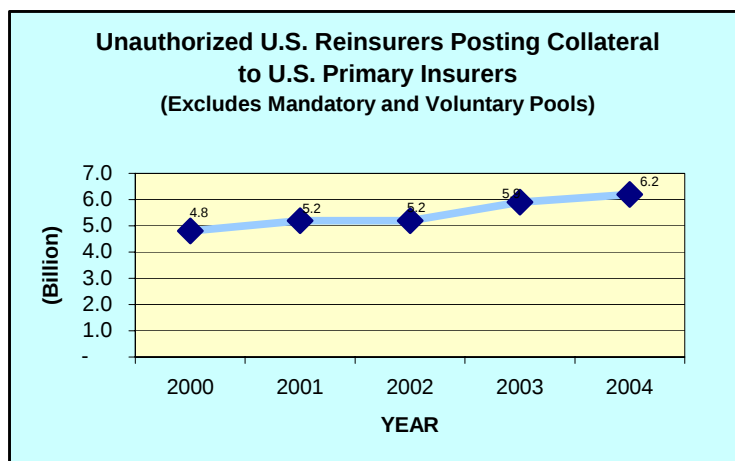
consists of all members). Normally the Dispute Settlement Body makes a ruling by adopting the findings of a panel of experts or an appeal report. Even then, the scope of the ruling is narrow: it is simply a judgment or interpretation of whether a government has broken one of the WTO's agreements—agreements that the infringing government had itself accepted. If a government has broken a commitment it has to conform. In all other respects, the WTO does not dictate to governments to adopt or reject certain policies.

Many state insurance regulators and virtually all U.S. industry participants (primary insurers and reinsurers) consider reinsurance collateralization rules are not a barrier to trade or the U.S. reinsurance market. It seems implausible that U.S. reinsurance collateral requirements represent a significant barrier to trade since more than three-fourths of the U.S. ceded premiums ultimately go to non-U.S. entities.

Virtually all U.S. insurers (as well as some non-U.S. insurers who have not expressed a desire for change to the current U.S. reinsurance regulatory structure) consider that requiring unauthorized reinsurers to post collateral for 100% of their estimated liabilities represents a prudent solvency measure that has been employed by the U.S. insurance regulatory system for many years. The 100% funding requirement is only the primary insurer's currently estimated future liabilities. Depending on the long-term viability of the reinsurer and potential changes in the U.S. judicial system (e.g. asbestos reform), the current 100% collateral estimate might ultimately be found to be inadequate to pay claims that come due many years into the future.

The current U.S. system of collateralization requires unauthorized reinsurers, both U.S. and non-U.S., to fully fund claims that have already occurred within the U.S. and will be paid out to U.S. policyholders. This regulatory requirement affects both U.S. and non-U.S. reinsurers. The graph below indicates that U.S. licensed insurers have posted over \$6 billion in collateral on reinsurance business written with other U.S. licensed companies.

Figure 7 – Unauthorized U.S. Reinsurers Posting Collateral to U.S. Primary Insurers



Collateral requirements apply equally to U.S. and non-U.S. reinsurers based on the reinsurer's authorization status. This creates an incentive for U.S. reinsurers to be widely licensed, thus subjecting them to additional regulatory scrutiny. Under these rules, U.S. unauthorized reinsurers post over \$6

billion in collateral for the benefit of their ceding insurer clients. The non-U.S. share of the market continues to grow. Market share statistics document that the non-U.S. share of the U.S. reinsurance market is growing with nearly an equal split of the U.S. business ceded going to U.S. and non-U.S. reinsurers. The sum of non-U.S. and U.S. subsidiaries of non-U.S. reinsurers is nearly 85%.

Proven Track Record of Non-U.S. Reinsurers

Many of the oldest, largest and financially strongest reinsurers are located outside the U.S.

Pro-Change: The solvency record of the non-U.S. jurisdictions compares favorably with that of the U.S. The regulatory regimes of the largest and strongest reinsurers have developed and strengthened. Certain key regimes have implemented strong and effective controls and have open dialogue with U.S. regulators. Additionally, regulators in the U.S. have an increased knowledge of regulatory requirements in non-U.S. jurisdictions through continued communication with industry participants as well as regulatory dialogues. Non-U.S. entities have maintained multiple beneficiary trusts for a number of years, to support their reinsurance business. These reinsurers submit detailed financial reports on claims liabilities to evidence adequacy of reserves; detailed schedule F retrocession information (despite the fact that no credit is allowed for these); annual audit statements and actuarial certifications on reinsurance reserves. The reinsurer must also provide a supplemental trust fund, over and above the gross reserves in the MBT. It must file a properly executed ARI form (as U.S. reinsurers do) as evidence that it submits to state authority for examination. In addition, these reinsurers maintain close and regular contact with the domiciliary state regulator, answering questions and providing additional financial and other information on demand. These requirements are similar to those for alien excess and surplus lines writers have written direct business in the U.S. and have submitted to additional regulatory requirements such as those prescribed in the NAIC International Insurers Department (IID) Quarterly Listing of Alien Insurers. The IID Quarterly Listing requirements are as follows: (1) proof that the non-U.S. insurer continually maintains capital and/or surplus “adequate to its obligations, but in no event may the total amount be less than \$15,000,000 for any company applicant;” (2) establish a particular form of U.S. trust account in which is maintained no less than \$5.4 million, in addition to at least 30% of the insurer’s U.S. gross surplus lines liabilities or certain direct non-admitted U.S. liabilities; and (c) “an established reputation of financial integrity and satisfactory underwriting and claims practices” and must be controlled by personnel with high degrees of competence, experience, and integrity.

Pro-Maintenance: Many companies (e.g., Gerling, AXA, Trenwick) that have failed were considered paragons of strength only a few years before their collapse. A central purpose of insurance is to provide protection against low-frequency high-severity risks. Although the probability of failure may be low for many large international reinsurers, the impact could be catastrophic without collateral to provide a safety net. State credit for reinsurance rules are straightforward: the reinsurer must both domesticate and be licensed, or post collateral. This collateral option has allowed non-U.S. reinsurers substantial access to the U.S. market without subjecting themselves to state financial regulation and licensing. Many of the largest non-U.S. reinsurers own affiliated entities within the U.S., if they did not want to post collateral for those liabilities, then they simply would keep capital in the U.S. licensed entity. Instead, many choose voluntarily to transfer large amounts of premiums and liabilities back to the parent company being fully aware that any liabilities that are transferred out of the U.S. must be collateralized.

There are significant differences between the excess and surplus lines market and the reinsurance market in the U.S. that significantly limits the value of these comparisons. For example, surplus lines business is negotiated directly with policyholders. Surplus lines insurance is a caveat emptor voluntary market (with the exception of one state) with no guarantee fund protection for its insureds. Policyholders, claimants and regulators are relying on the solvency of licensed insurers who in return are relying on either the solvency of their authorized reinsurers or the collateral provided by their unauthorized reinsurers. Financial credit for reinsurance recoverables has a direct balance sheet impact as opposed to surplus lines business, where no such impact on policyholders exists.

Conclusion

This study was conducted with the objective of reviewing current U.S. reinsurance collateral requirements and to summarize the primary arguments surrounding the issue. The NAIC has examined this issue for some time as is indicated in this report.

Undoubtedly, this white paper will be updated and refined as additional information becomes available, and we continue to seek appropriate prudential methods for both reducing transactional costs while maintaining maximum solvency protection in order to benefit ceding insurers and U.S. policyholders.

The principal researchers and drafters of this document are Massachusetts Department of Insurance - Commissioner Julie Bowler and Senior Financial Analyst Robert DiBiasio, ARE, Georgia Department of Insurance - Commissioner John Oxendine and Chief Deputy Commissioner Justin Durrance, Virginia Department of Insurance – Commissioner Al Gross and Deputy Commissioner of Financial Regulation Doug Stolte, NAIC Senior Reinsurance Manager Bryan Fuller, CPCU, ARE, and NAIC Senior Financial Analyst – Reinsurance Ralph Villegas.

The task force acknowledges certain data limitations within Schedule F filings. The NAIC does subject this data to automated consistency validations, which check for valid Federal Identification Number (FEIN) and NAIC Company Code combinations as well as checking that financial amounts in the detail lines foot to subtotals, etc. Correction of these errors is dependent upon the insurer responding to NAIC correspondence. Corrections are made to filing errors in the demographic fields including Company Name, Group Name and Domicile, for issues not detected by the NAIC's automated validation process. This clean-up process results in more consistent and comprehensive search results. Every attempt was made to scrub the data and get figures that are consistent and relevant to the discussion.

Appendix I - Glossary

Throughout this paper a number of definitions and key words will be used in describing the concepts of reinsurance and its supervision.²³

Admitted (Authorized) Reinsurance - Reinsurance for which credit is given in the ceding company's Annual Statement because the reinsurer is licensed or otherwise authorized to transact business in the jurisdiction in question.

Alien - An insurer domiciled outside the United States.

Assume - To accept all or part of a ceding company's insurance or reinsurance on a risk or exposure.

Broker - An intermediary who negotiates reinsurance contracts between the ceding company and the reinsurer(s). The broker generally represents the ceding company and receives a commission, almost always from the reinsurer(s), for placing the business and performing other necessary services.

Broker Market - The collective reference to those reinsurance companies which accept business mainly from reinsurance brokers.

Capacity - The largest amount of insurance or reinsurance available from a company or the market in general. Also used to refer to the maximum amount of business (premium volume), which a company or the total market could write based on financial strength.

Cede - To transfer to a reinsurer all or part of the insurance or reinsurance risk written by a ceding company.

Ceding Company (Also Cedent (sometimes spelled “Cedant”), Reinsured, Reassured) – The insurer that cedes all or part of the insurance or reinsurance risk it has written to another insurer/reinsurer.

Cession - The amount of insurance risk transferred to the reinsurer by the ceding company.

Commutation Agreement - An agreement between the ceding insurer and the reinsurer that provides for the valuation, payment and complete discharge of all obligations between the parties under particular reinsurance contract(s). Although more common where the ceding insurer or reinsurer has concerns about the other party's financial condition, commutation agreements can be used whenever the parties wish to settle and discharge all future obligations.

Credit for Reinsurance - A statutory accounting procedure permitting a ceding company to treat amounts due from reinsurers as assets or reductions from liability based on the status of the reinsurer.

DAC (Deferred Acquisition Costs) - Under a deferral/matching approach the focus is to coordinate the

²³ The majority of definitions came from the Reinsurance Association of America's (RAA) Glossary of Terms.

timing of income and expense recognition so that both occur at the same time, when the triggering event that is the focus of the contract occurs. For example, under a deferral/matching approach the premium is not recognized when received but is instead recognized (“earned”) over the policy term during the period the insurance protection is provided. Likewise, the related expenses and incurred losses are not recognized when paid or committed to but are instead recognized over the same period as the premium. This may lead to the deferral of some up-front expenses, and the accrual of some losses that may take decades to pay. The deferral/matching approach requires the establishment of certain assets and liabilities to defer or accelerate recognition of revenue, expense or loss, in order to obtain the desired income statement effect. Hence the focus is on the income statement more than the balance sheet.

Under an asset/liability approach, the focus is on the value of assets or liabilities that exist as of the balance sheet date. An asset is booked if a right to a future stream of cash flows (or to an item that could be converted to future cash flows) existed at the reporting date. Likewise, a liability is booked if the entity was committed to an obligation at the balance sheet date that would result in the payment of future cash flows or other assets. Such an approach would not recognize a “deferred acquisition cost” as an asset if it cannot be transferred or translated as cash. It would also not recognize an unearned premium liability beyond that needed for future losses, expenses or returned premiums associated with that contract. In general, the focus of this approach is on the balance sheet, with the income statement essentially falling out as the difference between successive balance sheets.

Defense Cost and Containment Expense (DCC) Reserves - The expense incurred by the ceding insurer in the defense and settlement of claims under its policies but not the insurer's overhead expenses. The definition of DCC depends on the terms of the reinsurance contract.

Direct Writing Reinsurer - A reinsurance company, which develops its business by using its own personnel and does not (ordinarily) accept business from a broker or intermediary.

Evergreen Clause - A clause in a letter of credit providing for its automatic extension unless notice of nonrenewal is given sufficiently in advance of the scheduled expiration date.

Finite Reinsurance (Nontraditional Reinsurance, Limited Risk Reinsurance, and Financial Reinsurance) - A term used to describe a broad spectrum of treaty reinsurance arrangements, which provide reinsurance coverage at lower margins than traditional reinsurance, in return for a narrower range of possible loss to the reinsurer. This reinsurance is often multi-year and financially oriented, and can provide a means of financial management different from that usually provided by traditional reinsurance.

Foreign - An insurer that is domiciled in a jurisdiction other than the state in question. Usually used to refer specifically to an insurer domiciled in another U.S. state or possession, as distinguished from “non-U.S.” or “alien” insurer.

Funds Withheld - A provision in a reinsurance treaty under which the premium due the reinsurer, usually an unauthorized reinsurer, is not paid but rather is withheld by the ceding company to enable the ceding company to reduce the provision for unauthorized reinsurance in its statutory statement. The reinsurer's asset, in lieu of cash, is “Funds held by or deposited with reinsured companies.”

Incurred But Not Reported (IBNR) - The loss reserve value established by insurance and reinsurance companies in recognition of their liability for future payments on losses which have occurred but which have not yet been reported to them. This definition is often expanded to include adverse loss development on reported claims; however, the term Incurred But Not Enough Reported (IBNER) is coming into increased usage for that purpose, to more accurately reflect the distinction between true unreported claims and inadequately reserved reported claims.

Insurance - an economic activity for contractually reducing risk for the policyholder in return for the payment of premium. In effect, insurance spreads risk through pooling, in that loss by an individual policyholder is compensated for at the expense of all the other policyholders insured for the risk in question. Insurance can be offered on a sound basis when the pooled risks are sufficiently stable for the determination of a proper premium rate, so that the law of large number works for the independent risks.

Letter of Credit (LOC) – A banking instrument under which a bank undertakes to pay up to a given sum on demand at any time during a stated period, whether or not the party on whose account the funds are drawn is able to cover the draft. In the reinsurance context, a letter of credit is established on a “standby” basis to secure recoverables from non-admitted reinsurers to enable the ceding company to reduce the provision for unauthorized reinsurance in its statutory statement.

Loss Development - The difference between the estimated amount of loss(es) as reported at one date and the amount of an evaluation of the same loss(es) at a later date or the amount paid in final settlement(s).

Non-Admitted Reinsurance - Reinsurance for which no credit is given in the ceding company's statutory statement because the reinsurer is not licensed or authorized in the jurisdiction in question.

Primary - In reinsurance this term is applied to the nouns: insurer, insured, policy and insurance and means respectively: (1) the insurance company that initially originates the business; i.e., the ceding company; (2) the policyholder insured by the primary insurer; (3) the initial policy issued by the primary insurer to the primary insured; (4) the insurance covered under the primary policy issued by the primary insurer to the primary insured (sometimes called “underlying insurance”).

Provision for Reinsurance - Statutory accounting imposes “provisions” (or penalties) for certain types of reinsurance recoverables: unsecured recoverables from unauthorized reinsurers, unsecured recoverables from slow-paying (authorized) reinsurers, overdue recoverables from both authorized and unauthorized reinsurers, and recoverables in dispute from both authorized and unauthorized reinsurers. The provision for reinsurance is not necessarily a proxy for uncollectible reinsurance. For instance, the Statement of Actuarial Opinion must discuss reinsurance collectibility and its potential effect on loss reserve adequacy. The estimate of uncollectible reinsurance is distinct from the statutory provision for reinsurance: there may be a large provision for reinsurance despite no anticipated reinsurance collectibility problem.

Reinsurance - The transaction whereby the assuming insurer, for a consideration, agrees to indemnify the ceding company against all, or a part, of the loss which the latter may sustain under the policy or policies which it has issued.

Reinsured - See Ceding Company.

Reinsurer - The insurer (also referred to as the “Assuming Company”) that assumes all or a part of the insurance or reinsurance risk written by another insurer. More generally, an insurer that specializes or actively participates in the business of reinsurance.

Schedule F - The Annual Statement schedule which provides information on a property/casualty company’s reinsurance transactions.

“Substantially Similar” U.S. State – A state whose credit for reinsurance laws are substantially similar to those of the state in question, so that qualified reinsurers domiciled in that state may be like authorized reinsurers for purposes of credit for reinsurance.

Ultimate Net Loss - The term applied to the reinsurer’s loss under a reinsurance contract, generally the gross loss less any recoveries from other insurance, which inure to the benefit of the contract in question.

Unearned Premium Reserve (UPR) - The portion of a premium already received by the insurer under which protection has not yet been provided. The entire premium is not earned until the policy period expires, even though premiums are typically paid in advance.

Appendix II - Reinsurance Regulatory Requirements in Other Major Markets

Bermuda

In Bermuda, the major multinational reinsurance companies are companies falling into the Class 4 category. These are the companies that undertake the most significant professional reinsurance business, and they are required to have a statutory capital and surplus of at least U.S.\$ 100 million.

The Minimum Solvency Margin is the amount the statutory assets (i.e. admissible assets under the Insurance Act) of the reinsurer must exceed the statutory liabilities (as determined pursuant to the Insurance Act) by the prescribed amount. The minimum solvency margin for a Class 4 company is the greatest of Figures A, B and C below:

- Figure A: \$100,000,000;
- Figure B: 50% of the net premiums written in its current financial year or projected to be written on premiums ceded by the Class 4 company for reinsurance (not exceeding 25% of gross premiums written), of the premiums written in that year in respect of general business of the Class 4 company;
- Figure C: 15% of the aggregate of the reinsurer's loss expense provisions and other general business insurance reserves.

A class 4 reinsurer that fails to maintain its solvency margin requirement is prohibited from declaring or paying dividends until the deficit has been made good. The Insurance regulations require prior regulatory approval before making a material reduction to statutory capital and surplus (for example, through the declaration of a dividend). In addition, where a class 4 reinsurer's statutory capital and surplus fall below U.S.\$75 million, the Insurance legislation confers wide powers upon the Supervisor.

EU Directive on Reinsurance

In October 2005, the European Union adopted a Directive on reinsurance. The Directive extends to reinsurance undertakings the existing system for EU insurance undertakings under which the authorization and financial supervision is the responsibility of the supervisory authority of the Member State in which the reinsurance undertaking has its head office ('home country control') in accordance with harmonized reinsurance supervision rules. On this basis, reinsurance undertakings are able to operate throughout the EU ("single passport"), either by establishing themselves in other Member States, or by providing services directly from their home or another Member State.

The EU Reinsurance Directive sets out minimum regulatory requirements that Member States agreed amongst themselves were essential, necessary and sufficient for mutual recognition purposes and that are consistent with internationally agreed standards produced by bodies such as the IAIS (International Association of Insurance Supervisors).

The EU Reinsurance Directive prohibits Member States from introducing or keeping rules requiring EU reinsurers to post collateral. Rules requiring reinsurers to post collateral were prohibited, because it was felt that they represented both a barrier to the creation of an internal market and because a system based on mutual recognition was more appropriate for today's international reinsurance markets than a system that relies primarily on the posting of collateral.

Under the Directive, the home Member State will require every reinsurance undertaking seeking a license to limit its object to the business of reinsurance and related operations, to submit a scheme of operations and to possess the capital to fulfill the minimum guarantee fund requirement. The persons running the reinsurance company shall be of good repute and with appropriate professional qualifications or experience.

The Directive also sets out prudential rules for the supervision of reinsurance undertakings. These prudential rules are similar to those already applied in the Insurance Directives. It contains rules on the establishment of technical provisions, including the use of accepted actuarial methods for the purpose of calculating (mathematical) provisions, and rules on the investment of assets covering those technical provisions. It also lays down rules on required solvency margins and minimum capital requirements as well as rules on measures to be adopted by regulators if reinsurance undertakings are in financial difficulties. Reinsurance companies are obliged to report regularly to the supervisory authorities in accordance with their instructions. They shall ensure that they have sound administrative and accounting procedures and adequate internal control mechanisms.

Furthermore, under EU law, the financial statements of reinsurance undertakings have to be audited and auditors are required to communicate to competent authorities any possible infringement to the rules they may find whilst carrying out their duties.

Also, under the EU Reinsurance Directive, reinsurers as part of an insurance group are subject to supplementary supervision in accordance to the EU Directive dealing with Insurance Groups. Under the directive dealing with the supervision of financial conglomerates reinsurance companies are also included in the supplementary supervision."

France

Insurance and reinsurance companies in France are supervised by the Commission de Contrôle des Assurances, des Mutuelles et Institutions de Prévoyance (CCAMIP). The CCAMIP ensures that undertakings are in a position to meet (financial supervision) and do meet (performance supervision) their underwriting liabilities.

Direct insurers assuming reinsurance are subject to full direct supervision of their whole business. French direct insurers are subject to licensing requirements, minimum solvency (i.e. capital requirements), reporting requirements and investment restrictions (based on EU directives – coverage of technical liabilities with admitted assets).

French reinsurers are submitted to authorization and are supervised by the CCAMIP. In the present regulation, the supervision and solvency requirements applying to reinsurers are lighter than those applying to direct insurers. However these requirements will be reinforced by the implementation in France of the EU Reinsurance Directive.

Germany

Pure reinsurers have to meet the same standards as primary insurers concerning capital requirements. A respective amendment (sec. 119 to 121e and sec. 123b) of the German Insurance Supervision Law (Versicherungsaufsichtsgesetz - VAG) has been adopted at the end of 2004. Pursuant to sec 53c in

connection with sec 123b VAG, reinsurance companies have to have an amount of unattached equity capital, which enables them to fulfill their contractual obligations at any time. This amount has to be, as a minimum, at least as high as the required solvency margin; the overall business volume determines the solvency margin. With respect to defining solvency margin requirements, sec. 121d VAG refers to the respective European Community Directive (“Solvency I”). Insurance undertakings that carry on both reinsurance and primary insurance business have to subject their entire technical insurance and reinsurance business to the solvency requirements applicable to primary insurers – also based on the above-mentioned sections of the VAG and on the Solvency I Directive. Moreover, reinsurers are to be taken into account in the calculation of the adjusted solvency margin of an insurance group and of a financial conglomerate.

The supervisory authority may take any precautions and orders which are necessary to ensure that reinsurance undertakings are able to meet their obligations arising from reinsurance relationships at all times. The funds of reinsurers have to be adequate in order to fulfill all obligations under the existing reinsurance contracts.

United Kingdom

The FSA requires that a firm must at all times maintain overall financial resources, including capital resources and liquidity resources, which are adequate, both as to the amount and quality, to ensure that there is no significant risk that its liabilities cannot be met as they fall due. The UK does not differentiate between insurers and reinsurers for these purposes.

Firms must, as a minimum, meet the European Community Directive requirements. The EC requirement is based on the higher of a percentage of premiums or a percentage of claims calculation, with a minimum. In addition, the FSA requires firms to make their own assessment of the capital it needs given the nature of risks and risk mitigation that the firm has. The FSA reviews these firm assessments and may then give guidance to the firm as to the amount of capital the FSA considers it should hold. If the firm does not meet this level of capital, the FSA is able to restrict the amount of business the firm writes, or take other regulatory action. In addition firms are required to report the result of a risk based capital calculation with percentages applied to premiums, claims, and assets, with the percentages depending on the line of business, and generally expected to explain how their own capital assessment differs from this risk based calculation.

Lloyd’s is also subject to the capital assessment framework described in the previous paragraph. For Lloyd’s, the same principles apply, but the nature of this unique market means that there are differences in application. Each member has to hold a level of capital as assessed by Lloyd’s annually. Each managing agent is required to assess, for each of the syndicates, the amount of capital required to support the risks that the syndicate is exposed to. The level of capital is subject to the EC minimum and regulatory review by the FSA.

Italy

Reinsurance companies are authorized and supervised by the Istituto per la vigilanza sulle assicurazioni – ISVAP.

Currently the solvency requirements for primary insurers are not applicable to pure reinsurers that undertake exclusively reinsurance business. However the reinsurance undertakings are required to own a

minimum capital requirement that varies from a minimum of \$1 million Euros to a maximum of \$5 million Euros according to the classes pursued.

Moreover the submission of a scheme of the operations that the reinsurance undertaking intends to pursue is one of the conditions for granting the authorization. The scheme of operations shall be accompanied by a technical report explaining the criteria according to which the scheme has been drawn up.

The members of the board of directors and supervisory board (Italian collegio sindacale) as well as managing directors must meet fit and proper requirements i.e. they must be of good repute and possess adequate professional experience and qualification.

Shareholders are subject to the requirements of good repute and financial soundness.

The reinsurance undertakings are obliged to set up technical provisions and to cover them with appropriate assets even though current regulations do not envisage any quantitative or qualitative limit for assets representing technical provisions.

ISVAP has the same powers of supervision and sanction as for insurance undertakings and – based on the examination of the annual accounts of reinsurance undertakings – may request information and documents, make remarks, raise objections and conduct inspections on the reinsurance companies' premises and on all aspects of their activity.

The regulations in force do not require collaterals to the reinsurance undertakings that operate in Italy in freedom of establishment or freedom of services.

Japan

Japan adopts a risk-based approach to regulatory capital requirements, which focuses on the major risks: insurance risk, assumed interest risk, asset management risk and operational risk (life and non-life business), and additionally catastrophe risk (non-life business).

Insurers are expected to maintain a regulatory minimum of 200% of the estimated value of the risks.

Switzerland

Pursuant to Art. 10 of the Insurance Supervisory Law (1978, as of 2000), Swiss reinsurers should provide necessary guarantee to the insured, in particular as regards their solvency and the organization and conduct of their business.

Accordingly, Swiss supervision procedures and industry practices require that a reinsurer's eligible or free capital amount to at least 20% of net premiums earned, but no less than CHF 10 million.

Draft regulations, currently being discussed, include detailed solvency margin and target capital requirements for Swiss reinsurers.

United States

In the U.S., individual states require reinsurers to maintain a minimum level of capital and surplus in order to establish and continue operations.

In addition, the NAIC has adopted a risk-based capital approach, which applies to both direct insurers and reinsurers, and requires a risk-based capital ratio of not less than 200%. Financial solvency is also monitored through the use of financial profile reports, prioritization tools and financial analysis. Separate risk-based capital formulae exist for life (re)insurers, property/casualty (re)insurers and health (re)insurers, using a four-tier system to indicate the severity of any capital deficiency. These formulae include components to assess risks related to reinsurance.

Where the risk-based capital requirement is lower than a state's minimum capital requirement, the higher figure is required.

Appendix III - Disclosure and Transparency

A study was carried out to look at the public disclosures of a sample of groups including significant reinsurance operations, covering the jurisdiction represented within the global reinsurance market statistics. Reference was made to publicly available consolidated financial statements and website information. This has been supplemented by further information from national supervisors within participating jurisdictions, including comments relating to regulation of reinsurers generally as well as specifically to disclosure.

It may be noted that EU listed groups will need to prepare consolidated financial statements in accordance with International Financial Reporting Standards with effect from January 1, 2005. This is significant because traditionally the different national accounting regimes for insurance companies have varied considerably. Following the need for a global standard in the field, the IASB has launched its project for an international financial reporting standard for insurance contracts. The valuation of insurance liabilities (technical provisions) is at the very center of an on-going discussion. Since insurance liabilities represent the insurer's obligations vis-à-vis the policyholders, the valuation of those liabilities is crucial for a true and fair view and proper assessment of an insurer's overall financial position and the determination of capital requirements.

Bermuda

There are five classes of license under the Insurance Act comprising Long-Term insurers and four non-life classes. The table below summarizes the different classes of license and the relevant key requirements of the Insurance Act. In Bermuda, companies falling into the Class 4 category undertake the most significant professional reinsurance business.

	CLASS 1	CLASS 2	CLASS 3	CLASS 4	LIFE
Type of Company	Captive companies with single parent, risks of parent and affiliates only	Multi-owner captives and single parent captives writing up to 20% unrelated business	Third party insurers and reinsurers (writing more than 20% unrelated business)	Highly capitalized (excess \$100m) writers of excess liability, property catastrophe, and/or reinsurance	Writers of life business and other long-term insurers
Minimum Capital	\$120,000	\$120,000	\$ 120,000	\$ 1,000,000	\$250,000
Minimum Capital & Surplus	\$120,000	\$250,000	\$1,000,000	\$100,000,000	\$250,000
Dividend Restrictions	Comply with solvency/liquidity requirement	Comply with solvency/liquidity requirement	Comply with solvency/liquidity requirement	If dividend greater than 25% of statutory capital and surplus require affidavit signed by 2 directors & principal representative stating that margins still met after dividend	Comply with solvency requirement (minimum Capital & Surplus)
Inability to meet requirements of Act at any time	Principal representative to report to Supervisor of Insurance within 30 days	Principal representative to report to Supervisor of Insurance within 30 days	Principal representative to report to Supervisor of Insurance within 30 days	Principal representative to report to Supervisor of Insurance within 30 days	Principal representative to report to Supervisor of Insurance within 30 days

	CLASS 1	CLASS 2	CLASS 3	CLASS 4	LIFE
Reduction of total statutory capital	Reduction by 15% below amount included in previous year's financial statements, requires BMA approval	Reduction by 15% below amount included in last year's financial statements requires BMA approval	Reduction by 15% below amount included in last year's financial statements requires BMA approval	If reduction greater than 15% of total statutory capital, apply for BMA approval, affidavit signed by 2 directors & principal representative stating that insurer will not fail relative margins & other information Supervisor of Insurance may require	Reduction by 15% below amount included in previous year's financial statements, requires BMA approval

Under the Insurance Act, every Class 4 insurer is required to file annually a statutory financial return and statutory financial statements within four months of the insurer's financial year-end. Penalty fines may be incurred if filings are not made as required. The statutory financial return includes:

- Audit opinion from an auditor approved by the Supervisor, stating that the auditor carried out a proper examination of the insurer's statutory financial statements, and that the examination was conducted in accordance with an accepted auditing standard.
- Cover sheet describing the types of business conducted, whether it is written on a direct/reinsurance basis, premium by related/unrelated categories, description of stop loss reinsurance cover, and whether loss reserves are discounted.
- A declaration of statutory ratios, which includes a premium to statutory capital and surplus ratio, a five-year operating ratio, and a change in statutory capital and surplus ratio.
- A Loss Reserve Specialist Opinion from a fully qualified actuary in respect to the insurer's loss and loss expense provisions.
- Schedule of Ceded Reinsurance, a list of the reinsurers the company has contracts with, including their jurisdiction, rating, premium ceded, amounts owing to the reinsurer and a listing of aged recoverables owed from the reinsurer.
- Form 1 – Statutory Balance Sheet – general business, a prescribed line-by-line listing of all assets, liabilities and statutory capital & surplus.
- Form 2 – Statutory Statement of Income – general business, a prescribed line-by-line listing of all revenues and expenses.
- Form 8 – Statutory Statement of Capital and Surplus, a detailed breakdown of the amounts that make up the statutory capital and surplus.
- Notes to the Statutory Financial Statements.

The regulations do not require any of the information submitted to be made available to the public. However, most of the Class 4 companies licensed in Bermuda are publicly traded in the U.S. stock markets, and file extensive financial disclosure statements with the U.S. Securities Exchange Commission ("SEC"). The generally high level of financial security in Bermuda, coupled with very stringent solvency margin requirements for the Class 4 sector, has allowed most of the Class 4 companies to achieve A ratings from the internationally recognized rating agencies.

All prepare audited financial statements and obtain A M Best's, Standard & Poor's, Moody's, and/or Fitch Ratings to which they submit extensive financial disclosure materials including both material quantitative and qualitative information.

Reinsurers present consolidated financial statements (balance sheets, income statements, cash flow statements, and statements of changes in equity). In addition, SEC rules require the comprehensive

disclosure regarding the use of financial instruments including their use of derivatives and other hedging activities. Further, the publicly traded companies are required to provide "market risk" disclosures, both quantitative and qualitative about all financial instruments presented "outside" the financial statements.

Moreover, market analysts such as Goldman Sachs and Merrill Lynch review detailed financial data and provide extensive reports on company performance and forecast for the future.

France

The current supervisory framework for reinsurance and insurance companies in France is based on a single set of accounts that is used for both accounting and supervisory purposes. These accounts - balance sheet, profit and loss account and annex, including a detailed list of investments – are public documents. Firms usually provide financial statements (balance sheets, income statements, cash flow statements and the complete list of investments with their localization, market and book value) with notes, which provide details on their premiums, assets, investments, liabilities and debt. Some information is also provided in the annual report (technical result with premiums, claims, provisions and expenses by class of business, and also premiums and claims by region, information on risk management, business strategy corporate management and retrocession). Some firms also disclose information on their share capital, alternative risk transfer, derivative financial instruments, and claims development triangle.

Parent companies also have to publish consolidated financial statements with notes on their consolidation methods and list of consolidated entities.

More detailed information is reported to the supervisor in the form of CCAMIP returns, referred as “C reports” (annual) and “T reports” (quarterly), which are not publicly available. The information provided by insurers and reinsurers in these returns includes:

- C1: Detailed technical results by insurance category and sub-category.
- C2: Liabilities and technical results by country.
- C3: Reinsurance accepted and ceded (with a distinction between intra-group and external reinsurance)
- C4: Premiums per type of guarantees.
- C5: Insurance liabilities and assets backing those liabilities (not for pure reinsurers).
- C6: Solvency margin: required margin and eligible equity components (not for pure reinsurers).
- C6 bis: Projection of the solvency requirement of the society for the next 5 years (not for pure reinsurers).
- C8: Description of the reinsurance covers (not for pure reinsurers).
- C9: Detailed list of the reinsurers and stress testing of the reinsurance cover (not for pure reinsurers).
- C10-C11-C12: loss development triangle by insurance category and sub-category (non-life).
- C20-C21: Detailed information per contract (life).
- T1: Information on activity (premium, number of contracts sailed, amount and number of claims occurred).
- T2: List of investment by class of assets (at book value and market value).
- T3: Stress testing analysis on assets and technical provisions.

- A “solvency report” where the society demonstrate its future solvency (where the society have to explain both their internal control and process to maintain their solvency but also the results of their balance sheet projection under different scenarios).
- A “report on the investment politics.”
- A “report on reinsurance politics” (not applied to pure reinsurers).

Germany

External Accounting

Reinsurers and insurers have to prepare financial statements in accordance with general rules and specific regulations. These financial statements are based on the German accounting standards set forth in the German Commercial Code and other regulations. These focus very much on the creditor and not on the investor. The principle of prudence has top priority.

Within 10 months of the financial year end, reinsurers have to draw up their annual accounts as well as an annual report. This generally happens much earlier. These documents must be submitted to the supervisor as soon as they have been drawn up, i.e., before they are made public.

The consolidated financial statements (balance sheet, income statement, cash flow statement, stockholder equity, comprehensive income, and retained earnings) include informative notes with details on their assets, market value investments, and liabilities; premiums, investment results and expenses. For the sample of reinsurers reviewed, companies offer information on their financial products business, including useful comments on their market, credit and liquidity risks, including ratings. Fair value of financial instruments is also available.

According to the Corporate Sector Supervision and Transparency Act (KonTraG) reinsurers have to set up a risk management system which identifies potential risks. Companies have an obligation to disclose information about such risks and the structure of the system. Additionally all reinsurers have to meet the requirements of the German Accounting Standard 5-20. Reinsurers have to prepare a risk report under the rules of this standard.

For the sample of reinsurers reviewed, disclosure includes details on the type, maturity, currency, and regional allocation of their assets and investments. Information on their provisions, debt (with some information on the characteristics of the instruments), and other liabilities is provided. Details on the class, claims, ratios, and regional allocation of premiums are available.

General information on their risk management, business strategy, affiliated and subsidiary companies and principal officers can be found.

Auditor's report

Reinsurers and insurers must have their annual accounts and the annual report audited by an auditor. BaFin has to be informed before his appointment and before the audit takes place. The contents of audit reports is stipulated in the 'regulation on auditor's reports' published by BaFin. Two copies of the audit report are to be sent to BaFin, together with the relating comments of the managing and the supervisory boards. Finally, the auditor's report on the managing board's statement about the relations with affiliated companies also needs to be presented.

Internal accounting

The term internal accounting refers to information an insurer has to submit to the supervisory authority only. The provisions applying to internal accounting are similar to the provisions for non-life insurers. They were laid down in a regulation in 1995²⁴ and last amended in 2005. The changes are part of a continuous improvement process at the BaFin aiming at a reduced administration effort and further risk oriented supervision. For this purpose some statements were omitted (compare the Global Reinsurance Market Report 2003) and some newly introduced (see below). The present provisions require all reinsurers to submit the documents mentioned below, which have to have a certain format. The documents, which insurers have to put forward, provide not only a more detailed breakdown of the external accounts. They also allow a closer look into the reinsurer's business.

The documents that are to be submitted:

- Balance sheet (statement 100).
- Profit and loss account (statement 200) - (excerpts for the technical account).
 - For the entire insurance business.
 - For the entire reinsurance business accepted by domestic ceding insurers.
 - For the entire reinsurance business accepted by foreign ceding insurers.
 - For each class of insurance – (very detailed split).
- Development of investments (statements 101).
- Income from and expenses for investments (statement 201).
- Statement 203 (newly introduced) additional information with respect to reinsurance, including details about individual technical profits and losses relating to the accepted reinsurance business (former statement 250). And information on inward and outward reinsurance business, by every direct insurer and reinsurer dealt with (former sample 1).
- Statement 251 (newly introduced) information about covering technical provisions.
- Statement 252 (newly introduced) information about the insurance-business and the contracts, and in particular details about technical claims provisions. Moreover, information about individual technical profits and losses relating to the accepted reinsurance business (former statement 250).
- Statement 604 (newly introduced) quarterly information about the technical reinsurance business.
- Statement 671 (newly introduced) every six months information about technical provisions and details about the assets of reinsurers.
- Statement 688 (newly introduced) forecasting with a yearly cut-off date (30.06.) the respective development of the following months in advance.

Finally, reinsurers also have to supply informal statements such as an outline of the methods they use for setting up the provision for claims outstanding.

²⁴ Accounting in accordance with the ordinance concerning the reporting by insurance undertakings to the Federal Insurance Supervisory Office.

Where applicable, the reinsurer has to present the consolidated financial statements, which may be prepared on the basis of either IAS or U.S. GAAP, including an auditor's report.

The reinsurer is subject to the rules applicable to group supervision, if a primary insurer is involved also.

In addition to information delivered on a regular basis, the supervisor may request from the reinsurer any other information it requires.

Italy

The primary information concerning reinsurance undertakings, available to any stakeholder is, generally speaking, contained in official company acts (accounts, annual report, internal and external auditors' reports, etc), regularly published by undertakings in conformity with existing domestic legislation.

Reinsurers as well as insurers must have their financial statements checked by an auditor.

As concerns financial statements, based on the Civil Code, insurance undertakings are obliged to file their financial statements with the Chamber of Commerce and also, based on sector regulations, to file the audit report from the auditor.

The deadline for the approval of the balance-sheet for pure reinsurers is 30 June (i.e. six months after the end of the year. On a reinsurance undertaking's request based on specific reasons, the deadline may be postponed up to 30 September.

Japan

Insurance companies in Japan, including reinsurance companies, are subject to the disclosure requirements of the Insurance Business Law and relevant Enforcement Regulations. The industry association sets out further standards on disclosure. These result in highly comprehensive and standardized disclosures by Japanese insurers, including reinsurers.

In addition to the primary consolidated financial statements (balance sheets, income statements, cash flow statements, statement of retained earnings), companies disclose general information on business strategy, organizational structure, senior management and shareholders, as well as detailed information on investment activities, insurance activities, risk and solvency.

Information on investment activities includes, for example, asset management policy (qualitative), investment by class of asset, return on investment by class of asset, information on maturity (for securities and loans), information on debtors (for loans) etc. Information on insurance activities includes, for example, details, by line of business, on policy liabilities, premiums, claims paid, insured amounts, underwriting profit, etc.

Also disclosed is information on derivatives such as the policy on the use of derivatives (qualitative) and notional and market values of derivatives by type of transactions. Information on risk includes a description on the risk management system and risk management policy. As for quantitative information, 'insurance risk', 'assumed interest risk' and 'asset management risk' are calculated and disclosed based on a formula set by the Financial Services Agency. The overall risk based capital adequacy ratio (solvency margin ratio) is also disclosed.

Details of the reports insurance companies are required to submit in connection with their financial results are included in “Financial statements” and “Business reports” as well as “Periodical monitoring” requirements.

1) Financial statement (required half yearly), which includes:

- Overview of business result (summarized business result, ratios related to company management, statement of profits / losses, statements of assets, liabilities and capital).
- Balance of major accounts (state of securities, etc., insurance policy reserve, claims provisions, liability reserve), requiring a detailed breakdown by type of security or by class of business line.
- Business expenses (including claims expenses), requiring a detailed breakdown by type of expense
- Business result (business result of primary insurance, number of business contracts, amount of claims payment by class of business line, net business result, direct net premiums, direct net claims paid by class of business line).
- Schedule of asset management (situation of asset management, proportion of assets invested with the same insurance company).
- State of risk-monitored loans (schedule required).
- Conditions of solvency adequacy for claims payment - Solvency Margin Ratio (Calculation of amount by type of risk is required).
- State of transaction with major shareholders.

2) Business report (required annually), which includes:

- Overview of business situation and result.
- Indicators showing business result.
- *A detailed breakdown or information for the above items is required.
- Shareholders’ meetings, etc. (report on shareholders’ meetings, dividend and surplus distribution, other matters to be reported).
- Balance sheets.
- Profit-loss statements.
- Statement of cash flows.
- Report on fund depreciation.
- Report on payment of fund interest.
- Report on profit appropriation.
- Report on loss disposition.
- State of securities (securities held for trading purposes, securities held for other purposes).
- Conditions of solvency adequacy for claims payment (Solvency Margin Ratio).

3) Periodical monitoring (required: (A) Monthly (B) Quarterly (C) Half yearly (D)Yearly), including:

- Current situation of insurance business (balance of insurance business (B), state related to the third filed business (B), state related to new business by way of subscription (B)).
- Liquidity risk (liquidity index (A), liquidity reserve (B)).
- Market risk (state of securities by purpose of holding (B), risk analysis table by category (B), state of derivative transaction (B), index related to securities retained (B), interest rate risk related to reserved account (B), equity holding state by type of industry (C), list of top 20 shareholding balance in Japan (C)).

- Credit risk (basic information by rating (C), list of top 20 loaned companies (C), state of assets for largely-loaned companies (C)).
- Others (situation of invested assets (B), balance sheet by asset remaining period (C)).

Switzerland

Swiss reinsurers publish balance sheets, income statements, shareholders' equity statements, and cash flow statements with informative notes to them. The consolidated information is complemented with information on business segments. These notes include information on investments (type of instrument, country, currency and maturity), derivative financial instruments (interest rate contracts, equity and index contracts, foreign currency and other instruments), acquisitions and dispositions, and debt in some detail.

Premiums are detailed by geographic allocation and line of business. Additional information on subsidiaries and equity investments is also available. General notes on the firms' risk management and business strategy complement the quantitative information.

United Kingdom

The Financial Services Authority (FSA) in the UK regulates both insurers and reinsurers, as well as Lloyd's, which is subject to the same requirements. For regulatory reporting purposes, no distinction is drawn between an insurer and a reinsurer.

The FSA's principal supervisory tool in monitoring UK authorized insurers and reinsurers is the requirement on these entities to complete and submit an audited return on an annual basis (the regulatory return). The regulatory return enables the FSA to monitor an insurer or reinsurer's solvency and also to assess any other risks and exposures the entity may face.

Each year an authorized insurer or reinsurer must prepare a regulatory return comprising, among other things, the revenue account, profit and loss account and balance sheet at the end of the year together with the annexed notes, statements, reports and certificates and it must be audited. The regulatory return must be submitted to the FSA within 2 months, 15 days of the year-end or if submitting electronically (on FSA Approved software) within 3 months.

The regulatory return is very detailed and comprises a number of standard forms, which must be completed.²⁵

Forms 9 to 17 report the detailed assets and liabilities (including derivatives) and profit and loss figures and compare these with solvency requirements.

The general business revenue (forms 20 to 39) largely comprises analyses of premiums and claims by class of insurance business. There are eleven accounting classes, broken down into eight classes for direct and facultative business and three classes for treaty reinsurance.

Accident year accounting is the normal basis of accounting for these forms. However the underwriting

²⁵ Forms 1 to 8 are no longer in use.

year accounting basis is also permitted and where this is adopted, a supplementary note must be included in respect of each accounting class, stating:

- (a) The reason for accounting for such business on an underwriting year basis.
- (b) The basis for distinguishing between such business and any other business falling within the same class accounted for on an accident year basis.
- (c) The accounting policy adopted for determining the provision for claims outstanding.
- (d) If the information provided in (a) to (c) differs in respect of risks incepted in the financial year in question from risks of a similar description incepted in previous financial years, the reason for the difference.

Information given for each accounting class is also further subdivided as follows:

- (a) Direct and facultative business is broken down by risk group within each country or reported on a reconciliation basis.
- (b) Treaty reinsurance business is broken down into business categories.

This information included in the revenue forms above is to allow the FSA to analyze, compare and monitor the performance by class of business and to assess the adequacy of claims provisions by comparing actual claims movements with technical provisions.

Companies writing long-term insurance business are required to complete forms 40 to 45, which give fuller details supporting the revenue forms and forms 46 to 61 give details supporting the valuation report by the appointed actuary.

The following details must also be provided:

- 1. Additional information on general insurance business reinsurance ceded.
- 2. Statements of major treaty reinsurers and cedants and facultative reinsurers (general insurers).
- 3. Statement of additional Information on derivative contracts.
- 4. Statement of information on controllers (UK insurers only).
- 5. Statement of information about the appointed actuary (life insurers).
- 6. Supplementary notes to the return to amplify the information given on the forms.
- 7. The certificates and auditors' report required by the regulations.

Companies in the UK generally adopt UK GAAP, which requires a significant amount of disclosure (detailed in Schedule 9a to the Companies Act 1985) and comply with applicable accounting standards, the ABI SORP as well as the Combined Code on Corporate Governance. In addition to the substantial information publicly available in the FSA returns, a considerable amount of information is also provided in the annual report (such as the segmental analysis usually provides an analysis of premiums, claims and expenses by region and major class of business). Information on assets and investments is normally summarized in the CEO's report, and details of the type of assets, their currency and investment returns are provided in the notes to the accounts. Information on risk the management framework and the management of key risk areas is included in the Statement of Corporate Governance.

United States

In the United States, from a regulatory standpoint, reinsurers are subject to the same regulatory template as employed for direct writing insurers. That means that they are required to disclose the same level of extensive information as direct writers and that information is completely available to the public.²⁶ The statement templates and instructions are specific to property and casualty insurance, life insurance, and health insurance.

The disclosures include a balance sheet, income statement, statement of cash flows, underwriting schedules showing direct, assumed and ceded premiums, losses and loss adjustment expenses by line of business (about 30 lines of business are included). Many of the financial schedules also include subtotals for affiliated/non-affiliated, authorized/unauthorized and pooling arrangements. Investments schedules detailing each investment held as of a reporting date by type of investment (i.e., real estate, mortgage loans, bonds, preferred stocks, common stocks, other invested assets and derivative type investments with approximately 30 data items per investment, including statutory values and fair values), historical paid and incurred loss and loss expense development experience by line of business including reserve performance and detailed reinsurance information showing the source of all assumed premiums and the destination of all transferred business through cessions (facultative and treaty). In addition, the disclosures require answers to numerous regulatory questions and detailed and formatted footnote disclosures. The statements disclose all investment activity in the interim of reporting periods and those interims are quarterly. Profit and loss per investment transactions are readily discernible.

Additionally, companies are required to file statements prepared by independent certified public accountants that disclose differences between their findings and those presented by companies in their filed statements. Also, companies are required to file, in the case of life companies, actuarial opinions and memoranda, and in the case of property/casualty insurers, loss reserve opinions, from qualified actuaries. The independent certified accountants' reports and the actuarial opinions are publicly available.

Publicly traded companies are also required to file additional information of the type noted above with the securities regulators. This information is also publicly available.

The regulatory system in the United States also provides that all material holding company transactions require filing prior to engagement. Some of those transactions above a relatively modest threshold actually require prior approval. Such transactions are disclosed to the public in the filed statutory statements. Mergers, acquisitions, changes in domicile, changes in form of an entity, changes in control, etc. all require prior regulatory approval. Sales of blocks of business require prior approval and appropriate disclosures. Dividends to stockholders are limited.

²⁶ See the NAIC website at <http://www.naic.org/insprod>.

Appendix IV -Accounting Standards

Comparison of U.S. GAAP and U.S. SAP

The objectives of GAAP reporting differ from the objectives of SAP. GAAP is designed to meet the varying needs of the different users of financial statements. SAP is designed to address the concerns of regulators, who are the primary users of statutory financial statements. It should be noted that it is not only the U.S. that draws a distinction between public (“GAAP”) reporting and regulatory (known in the U.S. as “SAP”) reporting. Many regimes require specific regulatory reporting; some based upon local GAAP supplemented with specific, detailed regulatory reporting formats. As a result of the different concerns, GAAP stresses measurement of emerging earnings of a business from period to period, (i.e., matching revenue to expense), while SAP stresses measurement of ability to pay claims in the future. This difference is best illustrated by reviewing the treatment of acquisition costs under GAAP and SAP. Under GAAP, acquisition costs are capitalized and released to earnings as the profits from the underlying insurance policies emerge (matching concept). Under SAP, such costs are expenses as incurred because a deferred asset is not available to satisfy policyholder obligations. In addition, for life insurance products, SAP mandated the use of conservative assumptions whereas under GAAP management establishes those assumptions. Therefore, life reserves are often higher under SAP than GAAP. This is not the case for property and casualty (P&C) reserves as both GAAP and SAP require those amounts to be established at management’s best estimate. Consequently, P&C reserves are often equal under GAAP and SAP.

The methods of accounting for certain aspects of reinsurance under GAAP may have varied from SAP, e.g., credit for reinsurance in unauthorized companies.

Efforts to harmonize international accounting standards are progressing, but more work needs to be done before the International Accounting Standards Board (IASB) will implement accounting guidance. The International Association of Insurance Supervisors has also been leading efforts to produce international regulatory standards. Amongst many others, they have published standards on the supervision of reinsurers and the supervision of reinsurance credit.

Financial or regulatory reporting – summary of major differences to U.S. GAAP in significant reinsurance jurisdictions

The items below are the identified areas, in the financial statements (in respect of U.S. entities the regulatory returns) of reporting reinsurers, where a material difference between national GAAP and U.S. GAAP could arise, as noted above many of these jurisdictions have additional regulatory reporting requirements (known in the U.S. as “SAP”). Aside from the U.S., this section covers only a comparison of GAAPs.

Bermuda

Reports in U.S. GAAP

France (French GAAP)

- Investments (carried at historical cost or amortized cost)
- Impairment provisions (valuation allowances) may be reversed if market conditions improve
- Realized gains/losses on fixed maturities sold before maturity are taken to capitalization reserve
- Embedded derivatives are not recognized
- Treasury shares included as an asset
- No deposit accounting (no concept of financial reinsurance)
- Cost of reinsurance recorded in year in which reinsurance arrangement placed
- DAC (life) – significant difference in definition
- DAC (non-life) – acquisition costs are deferred (rather than may be deferred); commission on reinsurance ceded not credited to DAC
- Provision for premium deficiency – based on historical benefits / losses; DAC is not offset
- Equalization reserves
- Universal life/investment contracts – total premiums recorded as revenue
- Technical/claims provisions (more prudent and not discounted)

Japan (J-GAAP)

- Contingency reserves (including ‘catastrophe’ and ‘price fluctuation’ reserves)
- DAC is prohibited in Japan
- IBNR (Minimal impact)

Germany (German GAAP - HGB)

- Financial assets (largely at market value under U.S. GAAP)
- Premium income (for life products only premiums related to risk transfer treated as premiums under U.S. GAAP)
- Provision for premium refunds (higher under HGB)
- Equalization reserve (under HGB)
- Technical/claims provisions (more prudent under HGB)
- Acquisition costs (capitalized and amortized under U.S. GAAP)
- Depreciation and valuation write-downs (not applied to temporary diminutions under U.S. GAAP)
- Equity accounting for interests in associates under U.S. GAAP (dividend distributions only under HGB)
- Goodwill (written off direct to reserves under HGB)

Switzerland (Swiss GAAP)

- Equalization reserves allowed under CH GAAP
- Fixed income securities available-for-sale may be measured at amortized cost for CH GAAP
- Goodwill may be amortized under CH GAAP
- Reversal of impairment charges allowed under CH GAAP under certain conditions

United Kingdom

(UK GAAP)²⁷

- Substantially the same as U.S. GAAP
- Loss reserves are not discounted, as they are under U.S. GAAP. (U.S. SAP takes the same approach as UK GAAP).
- Catastrophe reserves held as additional provision

United States (U.S. SAP)

Non-admitted assets:

- Fixtures and fittings
- Computer hardware and software(> 3% capital and surplus)
- Finite lived intangibles
- Goodwill > 10% capital and surplus
- DAC (expensed as incurred)
- Premiums/agents' balances outstanding for more than 90 days
- Deferred tax assets > 10% capital and surplus
- Investments > statutory maximum holdings
- Prepaid expenses

Liabilities:

- No discounting of loss reserves (exception for Worker's Compensation Insurance)
- Provision for uncollectible reinsurance (per prescribed calculation)
- Dividends may be recorded earlier under GAAP than SAP
- Asset valuation reserves (against credit related investment losses)
- Interest maintenance reserve (deferral of realized gains/losses over remaining life of investments)

Reinsurance recoverable:

- Amounts relating to unpaid losses are offset against loss liabilities instead of being included as an asset.

²⁷ Lloyd's underwriters now report under UK GAAP.

Appendix V –Credit for Reinsurance Model Law

CREDIT FOR REINSURANCE MODEL LAW

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Section 1. Purpose

The purpose of this Act is to protect the interest of insureds, claimants, ceding insurers, assuming insurers and the public generally. The legislature hereby declares its intent is to ensure adequate regulation of insurers and reinsurers and adequate protection for those to whom they owe obligations. In furtherance of that state interest, the legislature hereby provides a mandate that upon the insolvency of a non-U.S. insurer or reinsurer that provides security to fund its U.S. obligations in accordance with this Act, the assets representing the security shall be maintained in the United States and claims shall be filed with and valued by the state insurance commissioner with regulatory oversight, and the assets shall be distributed, in accordance with the insurance laws of the state in which the trust is domiciled that are applicable to the liquidation of domestic U.S. insurance companies. The legislature declares that the matters contained in this Act are fundamental to the business of insurance in accordance with 15 U.S.C. §§ 1011-1012.

Section 2. Credit Allowed a Domestic Ceding Insurer

Credit for reinsurance shall be allowed a domestic ceding insurer as either an asset or a reduction from liability on account of reinsurance ceded only when the reinsurer meets the requirements of Subsections A, B, C, D or E of this section. Credit shall be allowed under Subsections A, B or C of this section only as respects cessions of those kinds or classes of business which the assuming insurer is licensed or otherwise permitted to write or assume in its state of domicile or, in the case of a U.S. branch of an alien assuming insurer, in the state through which it is entered and licensed to transact insurance or reinsurance. Credit shall be allowed under Subsections C or D of this section only if the applicable requirements of Subsection F have been satisfied.

- A. Credit shall be allowed when the reinsurance is ceded to an assuming insurer that is licensed to transact insurance or reinsurance in this state.

Drafting Note: A state that provides for licensing of reinsurance by line, for consistency should adopt an amended version of Subsection A requiring the assuming insurer to be “licensed to transact reinsurance in this state.”

- B. (1) Credit shall be allowed when the reinsurance is ceded to an assuming insurer that is accredited as a reinsurer in this state. An accredited reinsurer is one that:
 - (a) Files with the commissioner evidence of its submission to this state’s jurisdiction;
 - (b) Submits to this state’s authority to examine its books and records;
 - (c) Is licensed to transact insurance or reinsurance in at least one state, or in the case of a U.S. branch of an alien assuming insurer, is entered through and licensed to transact insurance or reinsurance in at least one state;
 - (d) Files annually with the commissioner a copy of its annual statement filed with the insurance department of its state of domicile and a copy of its most recent audited financial statement and
 - (i) Maintains a surplus as regards policyholders in an amount not less than \$20,000,000 and whose accreditation has not been denied by the commissioner within ninety (90) days of its submission or
 - (ii) Maintains a surplus as regards policyholders in an amount less than \$20,000,000 and whose accreditation has been approved by the commissioner.
- (2) Credit shall not be allowed a domestic ceding insurer if the assuming insurer’s accreditation has been revoked by the commissioner after notice and hearing.

Drafting Note: To qualify as an accredited reinsurer, an assuming insurer must meet all of the requirements and the standards set forth in Subsection B. If the commissioner of insurance determines that the assuming insurer has failed to continue to meet any of these qualifications, the commissioner may, upon written notice and hearing, revoke accreditation.

- C. (1) Credit shall be allowed when the reinsurance is ceded to an assuming insurer that is domiciled in, or in the case of a U.S. branch of an alien assuming insurer is entered through, a state that employs standards regarding credit for reinsurance substantially similar to those applicable under this statute and the assuming insurer or U.S. branch of an alien assuming insurer:
 - (a) Maintains a surplus as regards policyholders in an amount not less than \$20,000,000; and

- (b) Submits to the authority of this state to examine its books and records.
- (2) The requirement of Section 2 C(1)(a) does not apply to reinsurance ceded and assumed pursuant to pooling arrangements among insurers in the same holding company system.

Drafting Note: The term “substantially similar” means standards that equal or exceed the standards of the enacting state, as determined by the commissioner of the enacting state. It is expected that the NAIC will maintain a list of states whose laws establish standards that equal or exceed the standards of this model act.

- D. (1) Credit shall be allowed when the reinsurance is ceded to an assuming insurer that maintains a trust fund in a qualified U.S. financial institution, as defined in Section 4B, for the payment of the valid claims of its U.S. ceding insurers, their assigns and successors in interest. To enable the commissioner to determine the sufficiency of the trust fund, the assuming insurer shall report annually to the commissioner information substantially the same as that required to be reported on the NAIC Annual Statement form by licensed insurers. The assuming insurer shall submit to examination of its books and records by the commissioner and bear the expense of examination.
- (2) (a) Credit for reinsurance shall not be granted under this subsection unless the form of the trust and any amendments to the trust have been approved by:
 - (i) The commissioner of the state where the trust is domiciled or
 - (ii) The commissioner of another state who, pursuant to the terms of the trust instrument, has accepted principal regulatory oversight of the trust.
- (b) The form of the trust and any trust amendments also shall be filed with the commissioner of every state in which the ceding insurer beneficiaries of the trust are domiciled. The trust instrument shall provide that contested claims shall be valid and enforceable upon the final order of any court of competent jurisdiction in the United States. The trust shall vest legal title to its assets in its trustees for the benefit of the assuming insurer’s U.S. ceding insurers, their assigns and successors in interest. The trust and the assuming insurer shall be subject to examination as determined by the commissioner.
- (c) The trust shall remain in effect for as long as the assuming insurer has outstanding obligations due under the reinsurance agreements subject to the trust. No later than February 28 of each year the trustee of the trust shall report to the commissioner in writing the balance of the trust and listing the trust’s investments at the preceding year-end and shall certify

the date of termination of the trust, if so planned, or certify that the trust will not expire prior to the following December 31.

- (3) The following requirements apply to the following categories of assuming insurer:
- (a) The trust fund for a single assuming insurer shall consist of funds in trust in an amount not less than the assuming insurer's liabilities attributable to reinsurance ceded by U.S. ceding insurers, and, in addition, the assuming insurer shall maintain a trusted surplus of not less than \$20,000,000.
 - (b) (i) In the case of a group including incorporated and individual unincorporated underwriters:
 - (I) For reinsurance ceded under reinsurance agreements with an inception, amendment or renewal date on or after August 1, 1995, the trust shall consist of a trusted account in an amount not less than the group's several liabilities attributable to business ceded by U.S. domiciled ceding insurers to any member of the group.
 - (II) For reinsurance ceded under reinsurance agreements with an inception date on or before July 31, 1995, and not amended or renewed after that date, notwithstanding the other provisions of this Act, the trust shall consist of a trusted account in an amount not less than the group's several insurance and reinsurance liabilities attributable to business written in the United States and
 - (III) In addition to these trusts, the group shall maintain in trust a trusted surplus of which \$100,000,000 shall be held jointly for the benefit of the U.S. domiciled ceding insurers of any member of the group for all years of account and
 - (ii) The incorporated members of the group shall not be engaged in any business other than underwriting as a member of the group and shall be subject to the same level of regulation and solvency control by the group's domiciliary regulator as are the unincorporated members.
 - (iii) Within ninety (90) days after its financial statements are due to be filed with the group's domiciliary regulator, the group shall provide to the commissioner an annual certification by the group's domiciliary regulator of the solvency of each underwriter member; or if a certification is unavailable, financial statements, prepared by independent public accountants, of each underwriter member of the group.

- (c) In the case of a group of incorporated underwriters under common administration, the group shall:
 - (i) Have continuously transacted an insurance business outside the United States for at least three (3) years immediately prior to making application for accreditation.
 - (ii) Maintain aggregate policyholders' surplus of at least \$10,000,000,000.
 - (iii) Maintain a trust fund in an amount not less than the group's several liabilities attributable to business ceded by U.S. domiciled ceding insurers to any member of the group pursuant to reinsurance contracts issued in the name of the group.
 - (iv) In addition, maintain a joint trusteed surplus of which \$100,000,000 shall be held jointly for the benefit of U.S. domiciled ceding insurers of any member of the group as additional security for these liabilities and
 - (v) Within ninety (90) days after its financial statements are due to be filed with the group's domiciliary regulator; make available to the commissioner an annual certification of each underwriter member's solvency by the member's domiciliary regulator and financial statements of each underwriter member of the group prepared by its independent public accountant.

Drafting Note: Unless otherwise stated, "commissioner" refers to the commissioner of insurance in the state where credit or a reduction from liability is taken.

Drafting Note: Consideration was given to deferring to state capital and surplus requirements as a threshold for the trusteed surplus, but it was concluded that, on the basis of risk exposure and current industry security practices, the standards for credit should be higher under Subsection D. The \$100,000,000 trusteed surplus requirement for a group including incorporated and individual unincorporated underwriters reflects the higher financial standards currently found among the states for a group of this type. The \$20,000,000 trusteed surplus requirement is an option available to assuming insurers that do not satisfy both the licensing and financial standards of Subsection B or C.

- E. Credit shall be allowed when the reinsurance is ceded to an assuming insurer not meeting the requirements of Subsections A, B, C or D of this section, but only as to the insurance of risks located in jurisdictions where the reinsurance is required by applicable law or regulation of that jurisdiction.

Drafting Note: For purposes of this subsection, "jurisdiction" refers to those jurisdictions other than the United States and also to any state, district or territory of the United States. Subsection E allows credit

to ceding insurers that are mandated by these jurisdictions to cede to state-owned or controlled insurance or reinsurance companies or to participate in pools, guaranty associations or residual market mechanisms.

- F. If the assuming insurer is not licensed or accredited to transact insurance or reinsurance in this state, the credit permitted by Subsections C and D of this section shall not be allowed unless the assuming insurer agrees in the reinsurance agreements:
 - (1)
 - (a) That in the event of the failure of the assuming insurer to perform its obligations under the terms of the reinsurance agreement, the assuming insurer, at the request of the ceding insurer, shall submit to the jurisdiction of any court of competent jurisdiction in any state of the United States, will comply with all requirements necessary to give the court jurisdiction, and will abide by the final decision of the court or of any appellate court in the event of an appeal and
 - (b) To designate the commissioner or a designated attorney as its true and lawful attorney upon who may be served any lawful process in any action, suit or proceeding instituted by or on behalf of the ceding company.
 - (2) This subsection is not intended to conflict with or override the obligation of the parties to a reinsurance agreement to arbitrate their disputes, if this obligation is created in the agreement.
- G. If the assuming insurer does not meet the requirements of Subsections A, B or C, the credit permitted by Subsection D of this section shall not be allowed unless the assuming insurer agrees in the trust agreements to the following conditions:
 - (1) Notwithstanding any other provisions in the trust instrument, if the trust fund is inadequate because it contains an amount less than the amount required by Subsection D(3) of this section, or if the grantor of the trust has been declared insolvent or placed into receivership, rehabilitation, liquidation or similar proceedings under the laws of its state or country of domicile, the trustee shall comply with an order of the commissioner with regulatory oversight over the trust or with an order of a court of competent jurisdiction directing the trustee to transfer to the commissioner with regulatory oversight all of the assets of the trust fund.
 - (2) The assets shall be distributed by and claims shall be filed with and valued by the commissioner with regulatory oversight in accordance with the laws of the state in which the trust is domiciled that are applicable to the liquidation of domestic insurance companies.
 - (3) If the commissioner with regulatory oversight determines that the assets of the trust fund or any part thereof are not necessary to satisfy the claims of the U.S. ceding insurers of the grantor of the trust, the assets or part thereof shall be

returned by the commissioner with regulatory oversight to the trustee for distribution in accordance with the trust agreement.

- (4) The grantor shall waive any right otherwise available to it under U.S. law that is inconsistent with this provision.

Section 3. Asset or Reduction from Liability for Reinsurance Ceded by a Domestic Insurer to an Assuming Insurer not Meeting the Requirements of Section 2

An asset or a reduction from liability for the reinsurance ceded by a domestic insurer to an assuming insurer not meeting the requirements of Section 2 shall be allowed in an amount not exceeding the liabilities carried by the ceding insurer. The reduction shall be in the amount of funds held by or on behalf of the ceding insurer, including funds held in trust for the ceding insurer, under a reinsurance contract with the assuming insurer as security for the payment of obligations thereunder, if the security is held in the United States subject to withdrawal solely by, and under the exclusive control of, the ceding insurer; or, in the case of a trust, held in a qualified U.S. financial institution, as defined in Section 4B. This security may be in the form of:

- A. Cash;
- B. Securities listed by the Securities Valuation Office of the National Association of Insurance Commissioners and qualifying as admitted assets;
- C.
 - (1) Clean, irrevocable, unconditional letters of credit, issued or confirmed by a qualified U.S. financial institution, as defined in Section 4A, effective no later than December 31 of the year for which the filing is being made, and in the possession of, or in trust for, the ceding company on or before the filing date of its annual statement.
 - (2) Letters of credit meeting applicable standards of issuer acceptability as of the dates of their issuance (or confirmation) shall, notwithstanding the issuing (or confirming) institution's subsequent failure to meet applicable standards of issuer acceptability, continue to be acceptable as security until their expiration, extension, renewal, modification or amendment, whichever first occurs or

Drafting Note: Providing for the continuing acceptability of letters of credit whose issuers were acceptable when the credit support facility was first obtained is intended to avoid abrupt interruptions in the acceptability of credit support arrangements that run for specific periods of time, and thus unnecessary disruptions in the marketplace, on account of the issuing (or confirming) institution's subsequent failure to meet applicable standards of issuer acceptability (whether by virtue of a change in the issuing institution's ability to qualify under the original standards or as a result of revisions to the applicable standards). The provision stipulates that letters of credit acceptable when first obtained will, in the event of the subsequent nonqualification of the issuing (or confirming) institution, continue to be acceptable as security until the account party and beneficiary would first have, in the normal course of business, an opportunity to replace the credit support facility.

- D. Any other form of security acceptable to the commissioner.

Drafting Note: There is no implication in the requirement that the security for the payment of obligations must be held under the exclusive control of the ceding insurer that either the reserve liability or the assets held in relation to the reserve liability have not been transferred for the purposes of statutory accounting by the ceding insurer to the reinsurer.

Optional Section Drafting Note: This model act applies only to the domestic ceding insurers of the enacting state. However, if the enacting state wishes to impose credit for reinsurance standards on foreign insurers, the following language should be inserted as Section 4 and the succeeding sections of the model act should be renumbered accordingly:

Section []. Credit Allowed a Foreign Ceding Insurer [Optional]

- A. Credit for reinsurance or reduction from liability shall be allowed a foreign ceding insurer to the extent that credit has been allowed by the ceding insurer's state of domicile if:
- (1) The state of domicile is accredited by the National Association of Insurance Commissioners or
 - (2) Credit or reduction from liability would be allowed under this statute if the foreign ceding insurer were domiciled in this state.
- B. Credit for reinsurance or reduction from liability may be disallowed a foreign ceding insurer upon a finding by the commissioner that neither the condition of the reinsurer nor the collateral or other security provided by the reinsurer satisfies the credit for reinsurance requirements of this Act applicable to ceding insurers domiciled in this state.

Section 4. Qualified U.S. Financial Institutions

- A. For purposes of Section 3C, a "qualified U.S. financial institution" means an institution that:
- (1) Is organized or (in the case of a U.S. office of a foreign banking organization) licensed, under the laws of the United States or any state thereof.
 - (2) Is regulated, supervised and examined by U.S. federal or state authorities having regulatory authority over banks and trust companies and
 - (3) Has been determined by either the commissioner or the Securities Valuation Office of the National Association of Insurance Commissioners to meet such standards of financial condition and standing as are considered necessary and appropriate to regulate the quality of financial institutions whose letters of credit will be acceptable to the commissioner.

Drafting Note: The NAIC’s Securities Valuation Office (SVO) maintains, on a current basis, a list of all U.S. financial institutions that have, upon application to the SVO, been determined to meet the eligibility standards of its *Purposes and Procedures Manual*. These standards, developed by the NAIC’s Letter of Credit (EX4) Study Group, make use of nationally recognized ratings services, and are more rigorous in the case of foreign banking organizations (whose standby letters of credit must be issued or confirmed by a qualified U.S. financial institution) than those that are applicable to domestic financial institutions whose standby letters of credit would be considered acceptable.

- B. A “qualified U.S. financial institution” means, for purposes of those provisions of this law specifying those institutions that are eligible to act as a fiduciary of a trust, an institution that:
- (1) Is organized, or in the case of a U.S. branch or agency office of a foreign banking organization, licensed, under the laws of the United States or any state thereof and has been granted authority to operate with fiduciary powers and
 - (2) Is regulated, supervised and examined by federal or state authorities having regulatory authority over banks and trust companies.

Drafting Note: Because assets held in a fiduciary capacity are not subject to the claims of the trustee’s creditors, and because the trust departments of all U.S. financial institutions (including U.S. branch or agency offices of foreign banking organizations having fiduciary powers in the U.S.) are regulated, supervised and examined by the institution’s primary U.S. bank regulatory authority (federal or state), there is no need to apply additional standards measuring the financial condition or standing of the institution, as in the case of determining those institutions whose standby letter of credit obligations will be considered acceptable.

Section 5. Rules and Regulations

The commissioner may adopt rules and regulations implementing the provisions of this law.

Drafting Note: It is recognized that credit for reinsurance also can be affected by other sections of the enacting state’s code, e.g., a statutory insolvency clause or an intermediary clause. It is recommended that states that do not have a statutory insolvency clause or an intermediary clause consider incorporating such clauses in their legislation.

Section 6. Reinsurance Agreements Affected

This Act shall apply to all cessions after the effective date of this Act under reinsurance agreements that have an inception, anniversary or renewal date not less than six (6) months after the effective date of this Act.

Drafting Note: The enacting state may wish to provide a delay in the applicability greater than six (6) months to allow time for the insurance commissioner to promulgate regulations and to allow reinsurers to prepare and submit qualifying data.

Legislative History (All references are to the Proceedings of the NAIC).

1984 Proc. II 9, 29, 822, 836, 837-839 (adopted).

1986 Proc. I 9-10, 24, 799, 811, 812 (corrected).

1987 Proc. II 15, 24, 444-448, 832, 854, 856 (amended and reprinted).

1990 Proc. I 12-14, 851, 857-861 (amended at special plenary session September 1989 and reprinted).

1990 Proc. I 6, 30, 840, 872, 875-878 (technical amendments adopted at winter plenary and reprinted).

1990 Proc. II 7, 18, 748, 766, 780-783 (amended).

1993 Proc. 4th Quarter 6, 31, 835-836, 874, 891 (amended).

1996 Proc. 2nd Quarter 12, 12-17, 24, 862 (amended and reprinted).

Appendix VI –Credit for Reinsurance Model Regulation

CREDIT FOR REINSURANCE MODEL REGULATION

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Section 1. Authority

This regulation is promulgated pursuant to the authority granted by Sections [insert applicable section number] and [insert applicable section number] of the Insurance Code.

Section 2. Purpose

The purpose of this regulation is to set forth rules and procedural requirements that the commissioner deems necessary to carry out the provisions of the [cite state law equivalent to the Credit for Reinsurance Model Law] (the Act). The actions and information required by this regulation are declared to be necessary and appropriate in the public interest and for the protection of the ceding insurers in this state.

Section 3. Severability

If any provision of this regulation, or the application of the provision to any person or circumstance, is held invalid, the remainder of the regulation, and the application of the provision to persons or circumstances other than those to which it is held invalid, shall not be affected.

Section 4. Credit for Reinsurance—Reinsurer Licensed in this State

Pursuant to Section [cite state law equivalent of Section 2A of the Credit for Reinsurance Model Law] the commissioner shall allow credit for reinsurance ceded by a domestic insurer to an assuming insurer that was licensed in this state as of any date on which statutory financial statement credit for reinsurance is claimed.

Drafting Note: “Statutory financial statement” means quarterly, annual or other financial statements required by state law. The drafters conditioned the recognition of credit on matters reported, existing or occurring “as of any date on which” statutory financial statement credit is claimed or a financial statement is filed to ensure that requisite conditions for credit exist at the time the credit is claimed or reported and that the conditions remained satisfied at all times thereafter until information reported in one statement was replaced by information reported in a subsequently filed statement. Insurers are to satisfy requisite conditions at the time credit is first taken and shall maintain compliance at all times thereafter in which the credit is taken. The drafters believe the requirements to be perpetual, not periodic.

Section 5. Credit for Reinsurance—Accredited Reinsurers

- A. Pursuant to Section [cite state law equivalent of Section 2B of the Credit for Reinsurance Model Law] the commissioner shall allow credit for reinsurance ceded by a domestic insurer to an assuming insurer that is accredited as a reinsurer in this state as of any date on which statutory financial statement credit for reinsurance is claimed. An accredited reinsurer:
- (1) Files a properly executed Form AR-1 (attached as an exhibit to this regulation) as evidence of its submission to this state’s jurisdiction and to this state’s authority to examine its books and records.
 - (2) Files with the commissioner a certified copy of a certificate of authority or other acceptable evidence that it is licensed to transact insurance or reinsurance in at least one state, or, in the case of a U.S. branch of an alien assuming insurer, is entered through and licensed to transact insurance or reinsurance in at least one state.
 - (3) Files annually with the commissioner a copy of its annual statement filed with the insurance department of its state of domicile or, in the case of an alien assuming insurer, with the state through which it is entered and in which it is licensed to transact insurance or reinsurance, and a copy of its most recent audited financial statement and
 - (a) Maintains a surplus as regards policyholders in an amount not less than \$20,000,000 and whose accreditation has not been denied by the commissioner within ninety (90) days of its submission; or

- (b) Maintains a surplus as regards policyholders of less than \$20,000,000, and whose accreditation has been approved by the commissioner.
- B. If the commissioner determines that the assuming insurer has failed to meet or maintain any of these qualifications, the commissioner may upon written notice and hearing revoke the accreditation. Credit shall not be allowed a domestic ceding insurer if the assuming insurer's accreditation has been revoked by the commissioner.

Section 6. Credit for Reinsurance—Reinsurer Domiciled in Another State

- A. Pursuant to Section [cite state law equivalent to Section 2C of the Credit for Reinsurance Model Law] the commissioner shall allow credit for reinsurance ceded by a domestic insurer to an assuming insurer that as of any date on which statutory financial statement credit for reinsurance is claimed:
 - (1) Is domiciled in (or, in the case of a U.S. branch of an alien assuming insurer, is entered through) a state that employs standards regarding credit for reinsurance substantially similar to those applicable under the Act and this regulation;

Drafting Note: This subsection is intended to apply to an assuming insurer domiciled in (or, in the case of the U.S. branch of an alien assuming insurer, entered through) another state only if the assuming insurer also is licensed in that state and is therefore subject to the application of the state's credit for reinsurance standards as the result of the imposition of licensure requirements and also regulatory oversight and examination as a domiciliary company.

- (2) Maintains a surplus as regards policyholders in an amount not less than \$20,000,000; and
 - (3) Files a properly executed Form AR-1 with the commissioner as evidence of its submission to this state's authority to examine its books and records.
- B. The provisions of this section relating to surplus as regards policyholders shall not apply to reinsurance ceded and assumed pursuant to pooling arrangements among insurers in the same holding company system. As used in this section, "substantially similar" standards mean credit for reinsurance standards that the commissioner determines equal or exceed the standards of the Act and this regulation.

Section 7. Credit for Reinsurance—Reinsurers Maintaining Trust Funds

- A. Pursuant to Section [cite state law equivalent to Section 2D of the Credit for Reinsurance Model Law] the commissioner shall allow credit for reinsurance ceded by a domestic insurer to an assuming insurer which, as of any date on which statutory financial statement credit for reinsurance is claimed, and thereafter for so long as credit for reinsurance is claimed, maintains a trust fund in an amount prescribed below in a qualified U. S. financial institution as defined in Section [cite state law equivalent to Section 4B of the Credit for Reinsurance Model Law] of the Act, for the payment of the

valid claims of its U.S. domiciled ceding insurers, their assigns and successors in interest. The assuming insurer shall report annually to the commissioner substantially the same information as that required to be reported on the National Association of Insurance Commissioners (NAIC) annual statement form by licensed insurers, to enable the commissioner to determine the sufficiency of the trust fund.

B. The following requirements apply to the following categories of assuming insurer:

- (1) The trust fund for a single assuming insurer shall consist of funds in trust in an amount not less than the assuming insurer's liabilities attributable to reinsurance ceded by U.S. domiciled insurers, and in addition, the assuming insurer shall maintain a trusteed surplus of not less than \$20,000,000.
- (2) (a) The trust fund for a group including incorporated and individual unincorporated underwriters shall consist of:
 - (i) For reinsurance ceded under reinsurance agreements with an inception, amendment or renewal date on or after August 1, 1995, funds in trust in an amount not less than the group's several liabilities attributable to business ceded by U. S. domiciled ceding insurers to any member of the group.
 - (ii) For reinsurance ceded under reinsurance agreements with an inception date on or before July 31, 1995, and not amended or renewed after that date, notwithstanding the other provisions of this regulation, funds in trust in an amount not less than the group's several insurance and reinsurance liabilities attributable to business written in the United States and
 - (iii) In addition to these trusts, the group shall maintain a trusteed surplus of which \$100,000,000 shall be held jointly for the benefit of the U. S. domiciled ceding insurers of any member of the group for all the years of account.
- (b) The incorporated members of the group shall not be engaged in any business other than underwriting as a member of the group and shall be subject to the same level of regulation and solvency control by the group's domiciliary regulator as are the unincorporated members. The group shall, within ninety (90) days after its financial statements are due to be filed with the group's domiciliary regulator, provide to the commissioner:
 - (i) An annual certification by the group's domiciliary regulator of the solvency of each underwriter member of the group; or

- (ii) If a certification is unavailable, a financial statement, prepared by independent public accountants, of each underwriter member of the group.
 - (3) (a) The trust fund for a group of incorporated insurers under common administration, whose members possess aggregate policyholders surplus of \$10,000,000,000 (calculated and reported in substantially the same manner as prescribed by the annual statement instructions and *Accounting Practices and Procedures Manual* of the NAIC) and which has continuously transacted an insurance business outside the United States for at least three (3) years immediately prior to making application for accreditation, shall:
 - (i) Consist of funds in trust in an amount not less than the assuming insurers' several liabilities attributable to business ceded by U. S. domiciled ceding insurers to any members of the group pursuant to reinsurance contracts issued in the name of such group and
 - (ii) Maintain a joint trusteed surplus of which \$100,000,000 shall be held jointly for the benefit of U. S. domiciled ceding insurers of any member of the group and
 - (iii) File a properly executed Form AR-1 as evidence of the submission to this state's authority to examine the books and records of any of its members and shall certify that any member examined will bear the expense of any such examination.
 - (b) Within ninety (90) days after the statements are due to be filed with the group's domiciliary regulator, the group shall file with the commissioner an annual certification of each underwriter member's solvency by the member's domiciliary regulators, and financial statements, prepared by independent public accountants, of each underwriter member of the group.
- C. (1) Credit for reinsurance shall not be granted unless the form of the trust and any amendments to the trust have been approved by either the commissioner of the state where the trust is domiciled or the commissioner of another state who, pursuant to the terms of the trust instrument, has accepted responsibility for regulatory oversight of the trust. The form of the trust and any trust amendments also shall be filed with the commissioner of every state in which the ceding insurer beneficiaries of the trust are domiciled. The trust instrument shall provide that:

- (a) Contested claims shall be valid and enforceable out of funds in trust to the extent remaining unsatisfied thirty (30) days after entry of the final order of any court of competent jurisdiction in the United States;
 - (b) Legal title to the assets of the trust shall be vested in the trustee for the benefit of the grantor's U. S. ceding insurers, their assigns and successors in interest;
 - (c) The trust shall be subject to examination as determined by the commissioner;
 - (d) The trust shall remain in effect for as long as the assuming insurer, or any member or former member of a group of insurers, shall have outstanding obligations under reinsurance agreements subject to the trust and
 - (e) No later than February 28 of each year the trustee of the trust shall report to the commissioner in writing setting forth the balance in the trust and listing the trust's investments at the preceding year-end, and shall certify the date of termination of the trust, if so planned, or certify that the trust shall not expire prior to the following December 31.
- (2)
- (a) Notwithstanding any other provisions in the trust instrument, if the trust fund is inadequate because it contains an amount less than the amount required by this subsection or if the grantor of the trust has been declared insolvent or placed into receivership, rehabilitation, liquidation or similar proceedings under the laws of its state or country of domicile, the trustee shall comply with an order of the commissioner with regulatory oversight over the trust or with an order of a court of competent jurisdiction directing the trustee to transfer to the commissioner with regulatory oversight over the trust or other designated receiver all of the assets of the trust fund.
 - (b) The assets shall be distributed by and claims shall be filed with and valued by the commissioner with regulatory oversight over the trust in accordance with the laws of the state in which the trust is domiciled applicable to the liquidation of domestic insurance companies.
 - (c) If the commissioner with regulatory oversight over the trust determines that the assets of the trust fund or any part thereof are not necessary to satisfy the claims of the U. S. beneficiaries of the trust, the commissioner with regulatory oversight over the trust shall return the assets, or any part thereof, to the trustee for distribution in accordance with the trust agreement.
 - (d) The grantor shall waive any right otherwise available to it under U.S. law that is inconsistent with this provision.

- D. For purposes of this regulation, the term “liabilities” shall mean the assuming insurer’s gross liabilities attributable to reinsurance ceded by U. S. domiciled insurers that are not otherwise secured by acceptable means, and, shall include:
- (1) For business ceded by domestic insurers authorized to write accident and health, and property and casualty insurance:
 - (a) Losses and allocated loss expenses paid by the ceding insurer, recoverable from the assuming insurer
 - (b) Reserves for losses reported and outstanding
 - (c) Reserves for losses incurred but not reported
 - (d) Reserves for allocated loss expenses
 - (e) Unearned premiums
 - (2) For business ceded by domestic insurers authorized to write life, health and annuity insurance:
 - (a) Aggregate reserves for life policies and contracts net of policy loans and net due and deferred premiums
 - (b) Aggregate reserves for accident and health policies
 - (c) Deposit funds and other liabilities without life or disability contingencies
 - (d) Liabilities for policy and contract claims
- E. Assets deposited in trusts established pursuant to [cite state law equivalent to Section 2 of the Credit for Reinsurance Model Law] and this section shall be valued according to their fair market value and shall consist only of cash in U.S. dollars, certificates of deposit issued by a U.S. financial institution as defined in [cite state law equivalent of Section 4A of the Credit for Reinsurance Model Law], clean, irrevocable, unconditional and “evergreen” letters of credit issued or confirmed by a qualified U.S. financial institution, as defined in [cite state law equivalent of Section 4A of the Credit for Reinsurance Model Law], and investments of the type specified in this subsection, but investments in or issued by an entity controlling, controlled by or under common control with either the grantor or beneficiary of the trust shall not exceed five percent (5%) of total investments. No more than twenty percent (20%) of the total of the investments in the trust may be foreign investments authorized under Paragraphs (1)(e), (3), (6)(b) or (7) of this subsection, and no more than ten percent (10%) of the total of the investments in the trust may be securities denominated in foreign currencies. For purposes of applying the preceding sentence, a depository receipt denominated in U.S. dollars and representing

rights conferred by a foreign security shall be classified as a foreign investment denominated in a foreign currency. The assets of a trust established to satisfy the requirements of Section [cite state law equivalent to Section 2 of the Credit for Reinsurance Model Law] shall be invested only as follows:

- (1) Government obligations that are not in default as to principal or interest, that are valid and legally authorized and that are issued, assumed or guaranteed by:
 - (a) The United States or by any agency or instrumentality of the United States
 - (b) A state of the United States
 - (c) A territory, possession or other governmental unit of the United States
 - (d) An agency or instrumentality of a governmental unit referred to in Subparagraphs (b) and (c) of this paragraph if the obligations shall be by law (statutory or otherwise) payable, as to both principal and interest, from taxes levied or by law required to be levied or from adequate special revenues pledged or otherwise appropriated or by law required to be provided for making these payments, but shall not be obligations eligible for investment under this paragraph if payable solely out of special assessments on properties benefited by local improvements, or
 - (e) The government of any other country that is a member of the Organization for Economic Cooperation and Development and whose government obligations are rated A or higher, or the equivalent, by a rating agency recognized by the Securities Valuation Office of the NAIC;
- (2) Obligations that are issued in the United States, or that are dollar denominated and issued in a non-U.S. market, by a solvent U. S. institution (other than an insurance company) or that are assumed or guaranteed by a solvent U. S. institution (other than an insurance company) and that are not in default as to principal or interest if the obligations:
 - (a) Are rated A or higher (or the equivalent) by a securities rating agency recognized by the Securities Valuation Office of the NAIC, or if not so rated, are similar in structure and other material respects to other obligations of the same institution that are so rated.
 - (b) Are insured by at least one authorized insurer (other than the investing insurer or a parent, subsidiary or affiliate of the investing insurer) licensed to insure obligations in this state and, after considering the insurance, are rated AAA (or the equivalent) by a securities rating agency recognized by the Securities Valuation Office of the NAIC or

- (c) Have been designated as Class One or Class Two by the Securities Valuation Office of the NAIC.
- (3) Obligations issued, assumed or guaranteed by a solvent non-U. S. institution chartered in a country that is a member of the Organization for Economic Cooperation and Development or obligations of U.S. corporations issued in a non-U.S. currency, provided that in either case the obligations are rated A or higher, or the equivalent, by a rating agency recognized by the Securities Valuation Office of the NAIC
- (4) An investment made pursuant to the provisions of Paragraph (1), (2) or (3) of this subsection shall be subject to the following additional limitations:
 - (a) An investment in or loan upon the obligations of an institution other than an institution that issues mortgage-related securities shall not exceed five percent (5%) of the assets of the trust.
 - (b) An investment in any one mortgage-related security shall not exceed five percent (5%) of the assets of the trust.
 - (c) The aggregate total investment in mortgage-related securities shall not exceed twenty-five percent (25%) of the assets of the trust and
 - (d) Preferred or guaranteed shares issued or guaranteed by a solvent U. S. institution are permissible investments if all of the institution's obligations are eligible as investments under Paragraphs (2)(a) and (2)(c) of this subsection, but shall not exceed two percent (2%) of the assets of the trust.
- (5) As used in this regulation:
 - (a) "Mortgage-related security" means an obligation that is rated AA or higher (or the equivalent) by a securities rating agency recognized by the Securities Valuation Office of the NAIC and that either:
 - (i) Represents ownership of one or more promissory notes or certificates of interest or participation in the notes (including any rights designed to assure servicing of, or the receipt or timeliness of receipt by the holders of the notes, certificates, or participation of amounts payable under, the notes, certificates or participation), that:
 - (I) Are directly secured by a first lien on a single parcel of real estate, including stock allocated to a dwelling unit in a residential cooperative housing corporation, upon which is located a dwelling or mixed residential and commercial structure, or on a residential manufactured home as defined

in 42 U.S.C.A. Section 5402(6), whether the manufactured home is considered real or personal property under the laws of the state in which it is located and

(II) Were originated by a savings and loan association, savings bank, commercial bank, credit union, insurance company, or similar institution that is supervised and examined by a federal or state housing authority, or by a mortgagee approved by the Secretary of Housing and Urban Development pursuant to 12 U.S.C.A. Sections 1709 and 1715-b, or, where the notes involve a lien on the manufactured home, by an institution or by a financial institution approved for insurance by the Secretary of Housing and Urban Development pursuant to 12 U.S.C.A. Section 1703 or

(ii) Is secured by one or more promissory notes or certificates of deposit or participations in the notes (with or without recourse to the insurer of the notes) and, by its terms, provides for payments of principal in relation to payments, or reasonable projections of payments, or notes meeting the requirements of Items (i)(I) and (i)(II) of this subsection.

(b) “Promissory note,” when used in connection with a manufactured home, shall also include a loan, advance or credit sale as evidenced by a retail installment sales contract or other instrument.

(6) Equity interests

(a) Investments in common shares or partnership interests of a solvent U. S. institution are permissible if:

(i) Its obligations and preferred shares, if any, are eligible as investments under this subsection and

(ii) The equity interests of the institution (except an insurance company) are registered on a national securities exchange as provided in the Securities Exchange Act of 1934, 15 U.S.C. §§ 78a to 78kk or otherwise registered pursuant to that Act, and if otherwise registered, price quotations for them are furnished through a nationwide automated quotations system approved by the National Association of Securities Dealers, Inc. A trust shall not invest in equity interests under this paragraph an amount exceeding one percent (1%) of the assets of the trust even though the equity interests are not so registered and are not issued by an insurance company.

- (b) Investments in common shares of a solvent institution organized under the laws of a country that is a member of the Organization for Economic Cooperation and Development, if:
 - (i) All its obligations are rated A or higher, or the equivalent, by a rating agency recognized by the Securities Valuation Office of the NAIC and
 - (ii) The equity interests of the institution are registered on a securities exchange regulated by the government of a country that is a member of the Organization for Economic Cooperation and Development.
 - (c) An investment in or loan upon any one institution's outstanding equity interests shall not exceed one percent (1%) of the assets of the trust. The cost of an investment in equity interests made pursuant to this paragraph, when added to the aggregate cost of other investments in equity interests then held pursuant to this paragraph, shall not exceed ten percent (10%) of the assets in the trust.
- (7) Obligations issued, assumed or guaranteed by a multinational development bank, provided the obligations are rated "A" or higher, or the equivalent, by a rating agency recognized by the Securities Valuation Office of the NAIC.

Drafting Note: Banks such as the International Bank for Reconstruction and Development, European Bank for Reconstruction and Development, Inter-American Development Bank, Asian Development Bank, African Development Bank, International Finance Corporation are intended to qualify under this section.

- (8) Investment companies
 - (a) Securities of an investment company registered pursuant to the Investment Company Act of 1940, 15 U.S.C. § 80a, are permissible investments if the investment company:
 - (i) Invests at least ninety percent (90%) of its assets in the types of securities that qualify as an investment under Paragraph (1), (2) or (3) of this subsection or invests in securities that are determined by the commissioner to be substantively similar to the types of securities set forth in Paragraph (1), (2) or (3) of this subsection or
 - (ii) Invests at least ninety percent (90%) of its assets in the types of equity interests that qualify as an investment under Paragraph (6)(a) of this subsection.

- (b) Investments made by a trust in investment companies under this paragraph shall not exceed the following limitations:
 - (i) An investment in an investment company qualifying under Subparagraph (a)(i) of this paragraph shall not exceed ten percent (10%) of the assets in the trust and the aggregate amount of investment in qualifying investment companies shall not exceed twenty-five percent (25%) of the assets in the trust and
 - (ii) Investments in an investment company qualifying under Subparagraph (a)(ii) of this paragraph shall not exceed five percent (5%) of the assets in the trust and the aggregate amount of investment in qualifying investment companies shall be included when calculating the permissible aggregate value of equity interests pursuant to Paragraph (6)(a) of this subsection.

(9) Letters of Credit

- (a) In order for a letter of credit to qualify as an asset of the trust, the trustee shall have the right and the obligation pursuant to the deed of trust or some other binding agreement (as duly approved by the commissioner), to immediately draw down the full amount of the letter of credit and hold the proceeds in trust for the beneficiaries of the trust if the letter of credit will otherwise expire without being renewed or replaced.
- (b) The trust agreement shall provide that the trustee shall be liable for its negligence, willful misconduct or lack of good faith. The failure of the trustee to draw against the letter of credit in circumstances where such draw would be required shall be deemed to be negligence and/or willful misconduct.

- F. A specific security provided to a ceding insurer by an assuming insurer pursuant to Section 9 of this regulation shall be applied, until exhausted, to the payment of liabilities of the assuming insurer to the ceding insurer holding the specific security prior to, and as a condition precedent for, presentation of a claim by the ceding insurer for payment by a trustee of a trust established by the assuming insurer pursuant to this section.

Section 8. Credit for Reinsurance Required by Law

Pursuant to Section [cite state law equivalent of Section 2E of the Credit for Reinsurance Model Law], the commissioner shall allow credit for reinsurance ceded by a domestic insurer to an assuming insurer not meeting the requirements of Section [cite state law equivalent of Sections 2A, B, C, D or other appropriate section of the of the Credit for Reinsurance Model Law] but only as to the insurance of risks located in jurisdictions where the reinsurance is required by the applicable law or regulation of that jurisdiction. As used in this section, “jurisdiction” means a state, district or territory of the United States and any lawful national government.

Drafting Note: Examples of assuming insurers for which credit may be allowed under this section include state owned or controlled insurance or reinsurance companies or ceding company participation in pools, guaranty associations or residual market mechanisms required by statute, regulation or administrative order.

Section 9. Asset or Reduction from Liability for Reinsurance Ceded to an Unauthorized Assuming Insurer not Meeting the Requirements of Sections 4 through 8

- A. Pursuant to Section [cite state law equivalent of Section 3 of the Credit for Reinsurance Model Law], the commissioner shall allow a reduction from liability for reinsurance ceded by a domestic insurer to an assuming insurer not meeting the requirements of Section [cite state law equivalent of Section 2 or other appropriate section of the Credit for Reinsurance Model Law] in an amount not exceeding the liabilities carried by the ceding insurer. The reduction shall be in the amount of funds held by or on behalf of the ceding insurer, including funds held in trust for the exclusive benefit of the ceding insurer, under a reinsurance contract with such assuming insurer as security for the payment of obligations under the reinsurance contract. The security shall be held in the United States subject to withdrawal solely by, and under the exclusive control of, the ceding insurer or, in the case of a trust, held in a qualified United States financial institution as defined in Section [cite state law equivalent of Section 4B of the Credit for Reinsurance Model Law] This security may be in the form of any of the following:
- (1) Cash;
 - (2) Securities listed by the Securities Valuation Office of the NAIC and qualifying as admitted assets;
 - (3) Clean, irrevocable, unconditional and “evergreen” letters of credit issued or confirmed by a qualified United States institution, as defined in Section [cite state law equivalent of Section 4A of the Credit for Reinsurance Model Law], effective no later than December 31 of the year for which filing is being made, and in the possession of, or in trust for, the ceding company on or before the filing date of its annual statement. Letters of credit meeting applicable standards of issuer acceptability as of the dates of their issuance (or confirmation) shall, notwithstanding the issuing (or confirming) institution’s subsequent failure to meet applicable standards of issuer acceptability, continue to be acceptable as security until their expiration, extension, renewal, modification or amendment, whichever first occurs; or
 - (4) Any other form of security acceptable to the commissioner.
- B. An admitted asset or a reduction from liability for reinsurance ceded to an unauthorized assuming insurer pursuant to this section shall be allowed only when the requirements of Section 13 and the applicable portions of Sections 10, 11 and 12 of this regulation have been satisfied.

Section 10. Trust Agreements Qualified under Section 9

A. As used in this section:

- (1) “Beneficiary” means the entity for whose sole benefit the trust has been established and any successor of the beneficiary by operation of law. If a court of law appoints a successor in interest to the named beneficiary, then the named beneficiary includes and is limited to the court appointed domiciliary receiver (including conservator, rehabilitator or liquidator).

Drafting Note: The NAIC has adopted the above definition as part of the “Uniform Letter of Credit.” However, the state may choose to utilize the following definition: “Beneficiary” includes any successor by operation of law of the named beneficiary, including without limitation any liquidator, rehabilitator, receiver or conservator.

- (2) “Grantor” means the entity that has established a trust for the sole benefit of the beneficiary. When established in conjunction with a reinsurance agreement, the grantor is the unlicensed, unaccredited assuming insurer.
- (3) “Obligations,” as used Subsection B (11) of this section means:
 - (a) Reinsured losses and allocated loss expenses paid by the ceding company, but not recovered from the assuming insurer.
 - (b) Reserves for reinsured losses reported and outstanding.
 - (c) Reserves for reinsured losses incurred but not reported and
 - (d) Reserves for allocated reinsured loss expenses and unearned premiums.

B. Required conditions.

- (1) The trust agreement shall be entered into between the beneficiary, the grantor and a trustee, which shall be a qualified United States financial institution as defined in Section [insert citation to state law equivalent to Section 4B of the Credit for Reinsurance Model Law].
- (2) The trust agreement shall create a trust account into which assets shall be deposited.
- (3) All assets in the trust account shall be held by the trustee at the trustee’s office in the United States.
- (4) The trust agreement shall provide that:

- (a) The beneficiary shall have the right to withdraw assets from the trust account at any time, without notice to the grantor, subject only to written notice from the beneficiary to the trustee.
 - (b) No other statement or document is required to be presented to withdraw assets, except that the beneficiary may be required to acknowledge receipt of withdrawn assets.
 - (c) It is not subject to any conditions or qualifications outside of the trust agreement and
 - (d) It shall not contain references to any other agreements or documents except as provided for in Paragraph (11) of this subsection.
- (5) The trust agreement shall be established for the sole benefit of the beneficiary.
- (6) The trust agreement shall require the trustee to:
 - (a) Receive assets and hold all assets in a safe place.
 - (b) Determine that all assets are in such form that the beneficiary, or the trustee upon direction by the beneficiary, may whenever necessary negotiate any such assets, without consent or signature from the grantor or any other person or entity.
 - (c) Furnish to the grantor and the beneficiary a statement of all assets in the trust account upon its inception and at intervals no less frequent than the end of each calendar quarter.
 - (d) Notify the grantor and the beneficiary within ten (10) days, of any deposits to or withdrawals from the trust account.
 - (e) Upon written demand of the beneficiary, immediately take any and all steps necessary to transfer absolutely and unequivocally all right, title and interest in the assets held in the trust account to the beneficiary and deliver physical custody of the assets to the beneficiary and
 - (f) Allow no substitutions or withdrawals of assets from the trust account, except on written instructions from the beneficiary, except that the trustee may, without the consent of but with notice to the beneficiary, upon call or maturity of any trust asset, withdraw such asset upon condition that the proceeds are paid into the trust account.
- (7) The trust agreement shall provide that at least thirty (30) days, but not more than forty-five (45) days, prior to termination of the trust account, written notification of termination shall be delivered by the trustee to the beneficiary.

- (8) The trust agreement shall be made subject to and governed by the laws of the state in which the trust is domiciled.
- (9) The trust agreement shall prohibit invasion of the trust corpus for the purpose of paying commission to, or reimbursing the expenses of, the trustee. In order for a letter of credit to qualify as an asset of the trust, the trustee shall have the right and the obligation pursuant to the deed of trust or some other binding agreement (as duly approved by the commissioner), to immediately draw down the full amount of the letter of credit and hold the proceeds in trust for the beneficiaries of the trust if the letter of credit will otherwise expire without being renewed or replaced.
- (10) The trust agreement shall provide that the trustee shall be liable for its negligence, willful misconduct or lack of good faith. The failure of the trustee to draw against the letter of credit in circumstances where such draw would be required shall be deemed to be negligence and/or willful misconduct.
- (11) Notwithstanding other provisions of this regulation, when a trust agreement is established in conjunction with a reinsurance agreement covering risks other than life, annuities and accident and health, where it is customary practice to provide a trust agreement for a specific purpose, the trust agreement may provide that the ceding insurer shall undertake to use and apply amounts drawn upon the trust account, without diminution because of the insolvency of the ceding insurer or the assuming insurer, only for the following purposes:
 - (a) To pay or reimburse the ceding insurer for the assuming insurer's share under the specific reinsurance agreement regarding any losses and allocated loss expenses paid by the ceding insurer, but not recovered from the assuming insurer, or for unearned premiums due to the ceding insurer if not otherwise paid by the assuming insurer.
 - (b) To make payment to the assuming insurer of any amounts held in the trust account that exceed 102 percent of the actual amount required to fund the assuming insurer's obligations under the specific reinsurance agreement or
 - (c) Where the ceding insurer has received notification of termination of the trust account and where the assuming insurer's entire obligations under the specific reinsurance agreement remain unliquidated and undischarged ten (10) days prior to the termination date, to withdraw amounts equal to the obligations and deposit those amounts in a separate account, in the name of the ceding insurer in any qualified U. S. financial institution as defined in Section [insert citation to state law equivalent of Section 4B of the Credit for Reinsurance Model Law] apart from its general assets, in trust for such uses and purposes specified in Subparagraphs (a) and (b) above as

may remain executory after such withdrawal and for any period after the termination date.

- (12) Notwithstanding other provisions of this regulation, when a trust agreement is established to meet the requirements of Section 9 in conjunction with a reinsurance agreement covering life, annuities or accident and health risks, where it is customary to provide a trust agreement for a specific purpose, the trust agreement may provide that the ceding insurer shall undertake to use and apply amounts drawn upon the trust account, without diminution because of the insolvency of the ceding insurer or the assuming insurer, only for the following purposes:
- (a) To pay or reimburse the ceding insurer for:
 - (i) The assuming insurer's share under the specific reinsurance agreement of premiums returned, but not yet recovered from the assuming insurer, to the owners of policies reinsured under the reinsurance agreement on account of cancellations of the policies and
 - (ii) The assuming insurer's share under the specific reinsurance agreement of surrenders and benefits or losses paid by the ceding insurer, but not yet recovered from the assuming insurer, under the terms and provisions of the policies reinsured under the reinsurance agreement.
 - (b) To pay to the assuming insurer amounts held in the trust account in excess of the amount necessary to secure the credit or reduction from liability for reinsurance taken by the ceding insurer or
 - (c) Where the ceding insurer has received notification of termination of the trust and where the assuming insurer's entire obligations under the specific reinsurance agreement remain unliquidated and undischarged ten (10) days prior to the termination date, to withdraw amounts equal to the assuming insurer's share of liabilities, to the extent that the liabilities have not yet been funded by the assuming insurer, and deposit those amounts in a separate account, in the name of the ceding insurer in any qualified U. S. financial institution apart from its general assets, in trust for the uses and purposes specified in Subparagraphs (a) and (b) of this paragraph as may remain executory after withdrawal and for any period after the termination date.
- (13) The reinsurance agreement may, but need not, contain the provisions required in Subsection D(1)(b) of this section, so long as these required conditions are included in the trust agreement.

- (14) Notwithstanding any other provisions in the trust instrument, if the grantor of the trust has been declared insolvent or placed into receivership, rehabilitation, liquidation or similar proceedings under the laws of its state or country of domicile, the trustee shall comply with an order of the commissioner with regulatory oversight over the trust or court of competent jurisdiction directing the trustee to transfer to the commissioner with regulatory oversight or other designated receiver all of the assets of the trust fund. The assets shall be applied in accordance with the priority statutes and laws of the state in which the trust is domiciled applicable to the assets of insurance companies in liquidation. If the commissioner with regulatory oversight determines that the assets of the trust fund or any part thereof are not necessary to satisfy claims of the U. S. beneficiaries of the trust, the assets or any part of them shall be returned to the trustee for distribution in accordance with the trust agreement.

C. Permitted conditions.

- (1) The trust agreement may provide that the trustee may resign upon delivery of a written notice of resignation, effective not less than ninety (90) days after the beneficiary and grantor receive the notice and that the trustee may be removed by the grantor by delivery to the trustee and the beneficiary of a written notice of removal, effective not less than ninety (90) days after the trustee and the beneficiary receive the notice, provided that no such resignation or removal shall be effective until a successor trustee has been duly appointed and approved by the beneficiary and the grantor and all assets in the trust have been duly transferred to the new trustee.
- (2) The grantor may have the full and unqualified right to vote any shares of stock in the trust account and to receive from time to time payments of any dividends or interest upon any shares of stock or obligations included in the trust account. Any interest or dividends shall be either forwarded promptly upon receipt to the grantor or deposited in a separate account established in the grantor's name.
- (3) The trustee may be given authority to invest, and accept substitutions of, any funds in the account, provided that no investment or substitution shall be made without prior approval of the beneficiary, unless the trust agreement specifies categories of investments acceptable to the beneficiary and authorizes the trustee to invest funds and to accept substitutions that the trustee determines are at least equal in market value to the assets withdrawn and that are consistent with the restrictions in Subsection D(1)(b) of this section.
- (4) The trust agreement may provide that the beneficiary may at any time designate a party to which all or part of the trust assets are to be transferred. Transfer may be conditioned upon the trustee receiving, prior to or simultaneously, other specified assets.

- (5) The trust agreement may provide that, upon termination of the trust account, all assets not previously withdrawn by the beneficiary shall, with written approval by the beneficiary, be delivered over to the grantor.
- D. Additional conditions applicable to reinsurance agreements:
- (1) A reinsurance agreement may contain provisions that:
 - (a) Require the assuming insurer to enter into a trust agreement and to establish a trust account for the benefit of the ceding insurer, and specifying what the agreement is to cover.
 - (b) Stipulate that assets deposited in the trust account shall be valued according to their current fair market value and shall consist only of cash in United States dollars, certificates of deposit issued by a United States bank and payable in United States dollars, and investments permitted by the Insurance Code or any combination of the above, provided investments in or issued by an entity controlling, controlled by or under common control with either the grantor or the beneficiary of the trust shall not exceed five percent (5%) of total investments. The reinsurance agreement may further specify the types of investments to be deposited. Where a trust agreement is entered into in conjunction with a reinsurance agreement covering risks other than life, annuities and accident and health, then the trust agreement may contain the provisions required by this paragraph in lieu of including such provisions in the reinsurance agreement;
 - (c) Require the assuming insurer, prior to depositing assets with the trustee, to execute assignments or endorsements in blank, or to transfer legal title to the trustee of all shares, obligations or any other assets requiring assignments, in order that the ceding insurer, or the trustee upon the direction of the ceding insurer, may whenever necessary negotiate these assets without consent or signature from the assuming insurer or any other entity.
 - (d) Require that all settlements of account between the ceding insurer and the assuming insurer be made in cash or its equivalent and
 - (e) Stipulate that the assuming insurer and the ceding insurer agree that the assets in the trust account, established pursuant to the provisions of the reinsurance agreement, may be withdrawn by the ceding insurer at any time, notwithstanding any other provisions in the reinsurance agreement, and shall be utilized and applied by the ceding insurer or its successors in interest by operation of law, including without limitation any liquidator, rehabilitator, receiver or conservator of such company, without diminution

because of insolvency on the part of the ceding insurer or the assuming insurer, only for the following purposes:

- (i) To pay or reimburse the ceding insurer for:
 - (I) The assuming insurer's share under the specific reinsurance agreement of premiums returned, but not yet recovered from the assuming insurer, to the owners of policies reinsured under the reinsurance agreement because of cancellations of such policies.
 - (II) The assuming insurer's share of surrenders and benefits or losses paid by the ceding insurer pursuant to the provisions of the policies reinsured under the reinsurance agreement and
 - (III) Any other amounts necessary to secure the credit or reduction from liability for reinsurance taken by the ceding insurer.
 - (ii) To make payment to the assuming insurer of amounts held in the trust account in excess of the amount necessary to secure the credit or reduction from liability for reinsurance taken by the ceding insurer.
- (2) The reinsurance agreement also may contain provisions that:
- (a) Give the assuming insurer the right to seek approval from the ceding insurer, which shall not be unreasonably or arbitrarily withheld, to withdraw from the trust account all or any part of the trust assets and transfer those assets to the assuming insurer, provided:
 - (i) The assuming insurer shall, at the time of withdrawal, replace the withdrawn assets with other qualified assets having a market value equal to the market value of the assets withdrawn so as to maintain at all times the deposit in the required amount or
 - (ii) After withdrawal and transfer, the market value of the trust account is no less than 102 percent of the required amount.
 - (b) Provide for the return of any amount withdrawn in excess of the actual amounts required for Paragraph (1)(e) of this subsection, and for interest payments at a rate not in excess of the prime rate of interest on the amounts held pursuant to Paragraph (1)(e) of this subsection.

- (c) Permit the award by any arbitration panel or court of competent jurisdiction of:
 - (i) Interest at a rate different from that provided in Subparagraph (b) of this paragraph.
 - (ii) Court or arbitration costs.
 - (iii) Attorney's fees.
 - (iv) Any other reasonable expenses.
- (3) Financial reporting. A trust agreement may be used to reduce any liability for reinsurance ceded to an unauthorized assuming insurer in financial statements required to be filed with this department in compliance with the provisions of this regulation when established on or before the date of filing of the financial statement of the ceding insurer. Further, the reduction for the existence of an acceptable trust account may be up to the current fair market value of acceptable assets available to be withdrawn from the trust account at that time, but such reduction shall be no greater than the specific obligations under the reinsurance agreement that the trust account was established to secure.
- (4) Existing agreements. Notwithstanding the effective date of this regulation, any trust agreement or underlying reinsurance agreement in existence prior to [insert date] will continue to be acceptable until [insert date], at which time the agreements will have to fully comply with this regulation for the trust agreement to be acceptable.
- (5) The failure of any trust agreement to specifically identify the beneficiary as defined in Subsection A of this section shall not be construed to affect any actions or rights that the commissioner may take or possess pursuant to the provisions of the laws of this state.

Section 11. Letters of Credit Qualified under Section 9

- A. The letter of credit must be clean, irrevocable, unconditional and issued or confirmed by a qualified United States financial institution as defined in Section [insert citation to state law equivalent of Section 4A of the Credit for Reinsurance Model Law]. The letter of credit shall contain an issue date and expiration date and shall stipulate that the beneficiary need only draw a sight draft under the letter of credit and present it to obtain funds and that no other document need be presented. The letter of credit also shall indicate that it is not subject to any condition or qualifications outside of the letter of credit. In addition, the letter of credit itself shall not contain reference to any other agreements, documents or entities, except as provided in Subsection I(1) of this section. As used in this section, "beneficiary" means the domestic insurer for whose benefit the letter of credit has been established and any successor of the beneficiary by operation of

law. If a court of law appoints a successor in interest to the named beneficiary, then the named beneficiary includes and is limited to the court appointed domiciliary receiver (including conservator, rehabilitator or liquidator).

Drafting Note: The NAIC has adopted the above definition as part of the “Uniform Letter of Credit.” However, the state may choose to utilize the following definition: “Beneficiary” includes any successor by operation of law of the named beneficiary, including without limitation any liquidator, rehabilitator, receiver or conservator.

- B. The heading of the letter of credit may include a boxed section containing the name of the applicant and other appropriate notations to provide a reference for the letter of credit. The boxed section shall be clearly marked to indicate that such information is for internal identification purposes only.
- C. The letter of credit shall contain a statement to the effect that the obligation of the qualified United States financial institution under the letter of credit is in no way contingent upon reimbursement with respect thereto.
- D. The term of the letter of credit shall be for at least one year and shall contain an “evergreen clause” that prevents the expiration of the letter of credit without due notice from the issuer. The “evergreen clause” shall provide for a period of no less than thirty (30) days notice prior to expiration date or nonrenewal.
- E. The letter of credit shall state whether it is subject to and governed by the laws of this state or the Uniform Customs and Practice for Documentary Credits of the International Chamber of Commerce (Publication 500), or any successor publication, and all drafts drawn thereunder shall be presentable at an office in the United States of a qualified United States financial institution.
- F. If the letter of credit is made subject to the Uniform Customs and Practice for Documentary Credits of the International Chamber of Commerce (Publication 500), or any successor publication, then the letter of credit shall specifically address and provide for an extension of time to draw against the letter of credit in the event that one or more of the occurrences specified in Article 17 of Publication 500 or any other successor publication, occur.
- G. The letter of credit shall be issued or confirmed by a qualified United States financial institution authorized to issue letters of credit, pursuant to Section [insert citation to state law equivalent to 4A of the Credit for Reinsurance Model Law].
- H. If the letter of credit is issued by a qualified United States financial institution authorized to issue letters of credit, other than a qualified United States financial institution as described in Subsection G of this section, then the following additional requirements shall be met:

- (1) The issuing qualified United States financial institution shall formally designate the confirming qualified United States financial institution as its agent for the receipt and payment of the drafts and
- (2) The “evergreen clause” shall provide for thirty (30) days notice prior to expiration date for nonrenewal.

I. Reinsurance agreement provisions.

- (1) The reinsurance agreement in conjunction with which the letter of credit is obtained may contain provisions that:
 - (a) Require the assuming insurer to provide letters of credit to the ceding insurer and specify what they are to cover;
 - (b) Stipulate that the assuming insurer and ceding insurer agree that the letter of credit provided by the assuming insurer pursuant to the provisions of the reinsurance agreement may be drawn upon at any time, notwithstanding any other provisions in the agreement, and shall be utilized by the ceding insurer or its successors in interest only for one or more of the following reasons:
 - (i) To pay or reimburse the ceding insurer for:
 - (I) The assuming insurer’s share under the specific reinsurance agreement of premiums returned, but not yet recovered from the assuming insurers, to the owners of policies reinsured under the reinsurance agreement on account of cancellations of such policies.;
 - (II) The assuming insurer’s share, under the specific reinsurance agreement, of surrenders and benefits or losses paid by the ceding insurer, but not yet recovered from the assuming insurers, under the terms and provisions of the policies reinsured under the reinsurance agreement and
 - (III) Any other amounts necessary to secure the credit or reduction from liability for reinsurance taken by the ceding insurer.
 - (ii) Where the letter of credit will expire without renewal or be reduced or replaced by a letter of credit for a reduced amount and where the assuming insurer’s entire obligations under the specific reinsurance remain unliquidated and undischarged ten (10) days prior to the termination date, to withdraw amounts equal to the assuming insurer’s share of the liabilities, to the extent that the

liabilities have not yet been funded by the assuming insurer and exceed the amount of any reduced or replacement letter of credit, and deposit those amounts in a separate account in the name of the ceding insurer in a qualified U. S. financial institution apart from its general assets, in trust for such uses and purposes specified in Subsection I(1)(b)(i) of this section as may remain after withdrawal and for any period after the termination date.

- (c) All of the provisions of Paragraph (1) of this subsection shall be applied without diminution because of insolvency on the part of the ceding insurer or assuming insurer.
- (2) Nothing contained Paragraph (1) of this subsection shall preclude the ceding insurer and assuming insurer from providing for:
 - (a) An interest payment, at a rate not in excess of the prime rate of interest, on the amounts held pursuant to Paragraph (1)(b) of this regulation or
 - (b) The return of any amounts drawn down on the letters of credit in excess of the actual amounts required for the above or any amounts that are subsequently determined not to be due.

Section 12. Other Security

A ceding insurer may take credit for unencumbered funds withheld by the ceding insurer in the United States subject to withdrawal solely by the ceding insurer and under its exclusive control.

Section 13. Reinsurance Contract

Credit will not be granted, nor an asset or reduction from liability allowed, to a ceding insurer for reinsurance effected with assuming insurers meeting the requirements of Sections 4, 5, 6, 7 or 9 of this regulation or otherwise in compliance with Section [cite state law equivalent of Section 2 of the Credit for Reinsurance Model Law] after the adoption of this regulation unless the reinsurance agreement:

- A. Includes a proper insolvency clause pursuant to Section [insert appropriate number] of the Insurance Code; and
- B. Includes a provision pursuant to Section [cite state law equivalent to Section 2F of the Credit for Reinsurance Model Law] whereby the assuming insurer, if an unauthorized assuming insurer, has submitted to the jurisdiction of an alternative dispute resolution panel or court of competent jurisdiction within the United States, has agreed to comply with all requirements necessary to give the court or panel jurisdiction, has designated an agent upon whom service of process may be effected, and has agreed to abide by the final decision of the court or panel.

Drafting Note: It is recognized that credit for reinsurance may be affected by other sections of the adopting state's code, e.g., the statutory insolvency or intermediary clauses. It is recommended that states that have statutory insolvency or intermediary clauses consider incorporating those clauses into this regulation.

Section 14. Contracts Affected

All new and renewal reinsurance transactions entered into after [insert date] shall conform to the requirements of the Act and this regulation if credit is to be given to the ceding insurer for such reinsurance.

Legislative History (all references are to the Proceedings of the NAIC).

1991 Proc. I 9, 18, 908, 926-927, 930-939 (adopted).

1996 Proc. 3rd Quarter 9, 41, 1109, 111, 1112-1125 (amended and reprinted).

2001 Proc. 1st Quarter 17, 738, 862, 863-872 (amended).

FORM AR-1

CERTIFICATE OF ASSUMING INSURER

I, _____,
(Name of officer) (title of officer)

of _____, the assuming insurer
(Name of assuming insurer)

Under a reinsurance agreement with one or more insurers domiciled in

_____, hereby certify that
(Name of state)

_____, (“Assuming Insurer”):
(Name of assuming insurer)

1. Submits to the jurisdiction of any court of competent jurisdiction in

(ceding insurer’s state of domicile)

for the adjudication of any issues arising out of the reinsurance agreement, agrees to comply with all requirements necessary to give such court jurisdiction, and will abide by the final decision of such court or any appellate court in the event of an appeal. Nothing in this paragraph constitutes or should be understood to constitute a waiver of Assuming Insurer’s rights to commence an action in any court of competent jurisdiction in the United States, to remove an action to a United States District Court, or to seek a transfer of a case to another court as permitted by the laws of the United States or of any state in the United States. This paragraph is not intended to conflict with or override the obligation of the parties to the reinsurance agreement to arbitrate their disputes if such an obligation is created in the agreement.

2. Designates the Insurance Commissioner of _____
(Ceding insurer’s state of domicile)

as its lawful attorney upon whom may be served any lawful process in any action, suit or proceeding arising out of the reinsurance agreement instituted by or on behalf of the ceding insurer.

3. Submits to the authority of the Insurance Commissioner of _____
_____ to examine its books and records
(Ceding insurer’s state of domicile)

And agrees to bear the expense of any such examination.

4. Submits with this form a current list of insurers domiciled in
_____ reinsured by Assuming Insurer and
(Ceding insurer’s state of domicile)

undertakes to submit additions to or deletions from the list to the Insurance Commissioner at least once per calendar quarter.

Dated: _____
(Name of assuming insurer)

BY: _____
(Name of officer)

(Title of officer)



4/11/06

