Insurance regulation – On the Move

Recent developments in reinsurance and surplus lines

Much focus has been put on insurers and their direct writing operations in recent years. However, the reinsurance and surplus lines markets are important in their own right for various reasons including their role in risk transfer, surplus relief and arbitrage to only name a few. These markets are often taken together as the players and the regulatory mechanics of the markets are often similar.

As we review recent regulatory developments in reinsurance and surplus lines with respect to the U.S. markets, it is important to discuss a few topics such as the internationalization of these markets (especially the reinsurance market), the NAIC's attempts at standardization and clarity, the federal government's recent forays into insurance regulation, and, finally, captives.

The International Tableau

Since much if not most reinsurance capacity comes from outside of the United States,[1] and many of the largest surplus lines insurers (often referred to as "nonadmitted insurers") also hail from outside of the United States, these markets implicate truly international issues cutting across almost all countries and jurisdictions. Recent developments in the insurance regulatory world highlight this fact and may have profound effects on the domestic insurance and reinsurance markets. Where U.S. domestics and the London market once dominated the landscape, major reinsurers and nonadmitted insurers are now peppered throughout the globe.

As the United States contemplates the reformation of reinsurance rules through federal regulation (e.g., the Nonadmitted and Reinsurance Reform Act (NRRA) passed as part of the Dodd-Frank Act), National Association of Insurance Commissioners (NAIC) edict (e.g., the Reinsurance Regulatory Modernization Framework and reinsurance reforms that are part of the Solvency Modernization Initiative), and new state regulation largely based upon the NAIC's lead (e.g., the recent collateral reforms passed by New York, Florida, New Jersey, and Indiana), legislators and regulators must balance strengthening reinsurer and nonadmitted insurer solvency requirements with cross-jurisdictional harmonization and coordination. As the reinsurance industry in particular faces significant challenges from a difficult catastrophe environment in 2011[2] and a continuing soft market,[3] it is that much more important that the United States gets regulatory reform right.

1 http://www.casact.org/newsletter/index.cfm?fa=viewart&id=6287

2 "Bermudian re/insurers' net income drops 85% in 2011," *Reactions*, April 20, 2012 (http://www.reactionsnet.com/Article/3015413/Bermudian-reinsurers-net-income-drops-85-in-2011.html)

3 "Fitch expects July rate rises to be limited," *BusinessDayOnline*, May 16, 2012 (http://www.businessdayonline.com/NG/index.php/news/38-insurance/37737-fitch-expects-july-rate-rises-to-be-limited)

The NAIC

Reinsurance Regulatory Modernization Framework and the Reinsurance Regulatory Modernization Act of 2009

At the urging of industry, the NAIC, which is the bellwether for insurance regulation and trends in the United States, began taking an in-depth look at the reinsurance regulatory regime in the latter part of the last decade. This review culminated in the NAIC's adoption of Reinsurance Regulatory Modernization Framework (RRMF) at its winter 2008 national meeting, which itself was the final of a number of prior proposals that were reviewed by the NAIC throughout 2007 and 2008.

What the NAIC found in its review of the U.S. reinsurance regulatory system was an uneven playing field where nonadmitted reinsurers—which were often alien reinsurers—were required to post collateral for 100 percent of assumed reinsurance liabilities in order for domestic ceding insurers to receive credit for the reinsurance, while a licensed or accredited domestic reinsurer was not required to post any collateral—regardless of its financial rating. In addition, reinsurers were faced with a 50-state regulatory system which could, at times, be duplicative and disjointed.

The RRMF sought to replace the 100 percent collateral requirement used throughout the United States with a requirement calculated based upon a sliding scale taking into account the financial strength rating of the nonadmitted reinsurer. Two classes of reinsurers would be formed—"national" reinsurers and "port of entry" (POE) reinsurers. A national reinsurer would be "licensed and domiciled in a [U.S.] home state and approved by such state to transact assumed reinsurance business across the United States while submitting solely to the regulatory authority of the home state supervisor for purposes of its reinsurance business."[4] A POE would be "a non-U.S. assuming reinsurer that is certified in a port of entry state and approved by such state to provide creditable reinsurance to the U.S. market."[5]

More importantly, the RRMF would provide a uniform regime in that a single lead state would be the sole U.S. regulator of a national or POE reinsurer across the United States. However, reinsurers would not be required to seek certification as a national or POE reinsurer, but could choose to continue operating under the regulatory framework extant at that time. In order to enforce this system, provisions would be made for the establishment of the NAIC Reinsurance Supervision Review Department (RSRD). A supervisory board of the RSRD (consisting of state insurance regulators) would, among other tasks, establish uniform standards for determining POE state and/or home state supervisor certification eligibility standards.

Mutual understanding agreements would be entered into between POE/home state supervisors and such eligible jurisdictions. A non-U.S. reinsurer located within such an eligible jurisdiction could then apply to qualified POE states to become a certified POE reinsurer.

Finally, the RRMF recommended implementation through federal enabling legislation to permit greater uniformity of application and to alleviate concerns regarding possible constitutional issues. During comment periods, commentators and regulators questioned the constitutionality of a proposal that encouraged state (or RSRD) negotiation and information sharing with foreign jurisdictions. In order to ease the federal and state adoption of the proposals in the RRMF, the NAIC subsequently approved draft legislation called the Reinsurance Regulatory Modernization Act of 2009 (RRMA).

Surplus lines

The surplus lines market, which may go by various names such as the excess and surplus market or the nonadmitted market, is absolutely essential to the proper function of the U.S. economy. Although estimates of the size of the market vary widely, its size in 2010 was estimated by a leading analysis firm at approximately $33B.[6]

One of the persistent challenges of the surplus lines market has been the apportionment of premium taxes to all states in which risks reside in proportion to the amount of risk in each state. Apportionment could become difficult in situations where there were various types of complex coverage across multiple states. In addition, property and casualty coverage was often treated differently and could lead to illogical or contradictory results—especially since states did not coordinate taxation—such that multiple states could each require that they be paid 100 percent of the premium tax.

In order to combat these and other issues, the NRRA was promulgated as part of the Dodd-Frank Act. The NRRA mandated a "home state" regime whereby only the home state of the insured would receive all surplus lines tax unless the states entered into tax allocation agreements among themselves. In order to combat the situation whereby the largest states which were home to the most insureds received almost all surplus lines taxes, two interstate compacts sprang into existence. The NAIC developed the Nonadmitted Insurance Multi-State Agreement (NIMA)[7] while the National Association of Professional Surplus Lines Offices (NAPSLO) created the Surplus Lines Insurance Multistate Compliance Compact (SLIMPACT).[8]

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[4] NAIC, *Reinsurance Regulatory Modernization Framework Proposal Memorandum* at *1, September 12, 2008

[5] NAIC, *Reinsurance Regulatory Modernization Framework Proposal Memorandum* at *1, September 12, 2008

[6] Simpson, Andrew G., "Surplus Lines Industry Losing Its Edge?," *Insurance Journal*, October 3, 2011 (http://www.insurancejournal.com/magazines/features/2011/10/03/218360.htm)

[7] http://www.floir.com/siteDocuments/NIMA09132011.pdf

[8] http://www.napslo.org/imispublic/PDF/Legreg/SLIMPACT_ExSum92807.pdf

NIMA provides a way for states to allocate premium tax on multistate risks among themselves by establishing a clearinghouse into which surplus lines brokers would pay taxes and which would then allocate the taxes to the applicable states based upon clear rules. Tax would not be the only benefit of utilizing a clearinghouse; proponents of NIMA also cite the ability to aggregate and disseminate data which in the past was only held in disparate locations. Importantly, casualty premium taxes—which have often in the past been disregarded by surplus lines brokers—would be allocated under the NIMA regime. As of this writing, although 11 states and territories had signed the NIMA pact representing 21.6 percent of the surplus lines marketplace based upon 2009 data,[9] Connecticut, Mississippi, and Alaska have recently submitted notice of withdrawal from NIMA.[10]

SLIMPACT and its slimmed down variant SLIMPACT-LITE provide a different vehicle for compliance with the NRRA mandate. SLIMPACT-LITE provides for the creation of a compact commission that would adopt rules on tax allocation, reporting, collection, and distribution, and may also adopt uniform insurer eligibility requirements. With respect to casualty business, it would require allocation of casualty premium among multiple states only where the underwriter conducted a premium allocation according to risk exposures in various states when pricing the risk. At present, only nine states have signed onto SLIMPACT, one short of the ten required in order to make SLIMPACT operative.[11]

Over 20 states have already adopted legislation in compliance with the NRRA and which allows the states to sign onto either NIMA or SLIMPACT. However, it is important to note that still other states, such as New York, have decided to go it alone and require 100 percent payment of the surplus lines premium tax be paid to the state where it is the insured's home state.

Credit for reinsurance

Over a decade of debate led to the NAIC's amending its Credit for Reinsurance Model Law and Regulation (the Credit for Reinsurance Model Act) in November 2011. Of primary concern in adopting these amendments was to implement reinsurance collateral reform that could be standardized across the states. A frustration for nonadmitted reinsurers with exceptional financial strength ratings was that they were required to post 100 percent collateral for reinsurance obligations in order for the domestic ceding insurer to take full reinsurance credit on its financial statements. This same collateral level was required no matter what level of financial strength the reinsurer maintained and no allowance was provided for different levels of insurer strength. Under the amended Credit for Reinsurance Model Act, collateral requirements may be reduced for alien reinsurers upon a sliding scale for reinsurers domiciled in countries that have strong systems of domestic insurance regulation. The NAIC's Reinsurance (E) Task Force has established a subgroup that is developing a process to review the reinsurance supervisory regimes of non-U.S. jurisdictions to determine the process by which jurisdictions can be added to a putative "white list" of jurisdictions to be considered "qualified jurisdictions" by states.[12]

Among other key developments that the NAIC is working on with respect to credit for reinsurance are assisting the states in implementing the Credit for Reinsurance Model Act, including developing related accreditation standards under the Financial Regulation Standards and Accreditation Program; and an advisory group to support states in the review of reinsurance collateral reduction applications.

A few items are noteworthy here. New collateral requirements will apply only on a prospective basis with existing liabilities continuing to be funded with 100 percent collateral. In addition, the immediate practical effects of lowered collateral requirements will be tempered by the fact that each state must adopt the Credit for Reinsurance Model Act amendments before those new standards become law. Furthermore, states are not required to adopt the new amendments and can choose to continue with 100 percent collateral requirements. Also, those insurers that become "certified reinsurers" domiciled outside of the United States should not lose sight of the new annual reporting requirements that come incident to the revised Credit for Reinsurance Model Act. There are a number of forms that would have to be filed with the domiciliary state of the ceding insurer. Reporting instructions are currently being developed by the Reinsurance Task Force with respect to these Forms CR-F and CR-S.

[9] Those states and territories that have joined NIMA are Florida, Hawaii, Louisiana, Nevada, Puerto Rico, South Dakota, Utah, and Wyoming (http://www.floir.com/Sections/PandC/NIMA.aspx).

[10] http://napslo.blogspot.com/2012_04_01_archive.html

[11] http://www.aamga.org/node/3572&sa=U&ei=xwO0T4uGD8jB6AHnhszTDw&ved=0CBEQFjAA&usg=AFQjCNGxYA08qgzFmljBVe14DD4Yg4PNlQ

[12] http://www.naic.org/committees_e_reinsurance.htm

As has been largely the case with the NAIC's Own Risk and Solvency Assessment (ORSA) process which has been followed closely by interested parties and observers, any additional changes to NAIC model laws and regulations could go through a one-year exposure period prior to consideration for adoption. Subsequently, it could take two to three years after NAIC adoption before new standards ultimately become state law. However, as with ORSA, there could likely be an expedited implementation approach applied to these new standards.

Some states, however, have already enacted the amendments to their respective credit for reinsurance laws, generally in line with NAIC and federal provisions. The four states—Florida, Indiana, New York and New Jersey—allow for lower collateral requirements through the use of a sliding scale based upon financial ratings and reinsurer surplus.[13] It is important to note that, although the Credit for Reinsurance Model Act applies to both property & casualty and life insurance risks, New York's Regulation 20 (Title 11 Part 125 (2010)) and Florida's F.A.C. Rule. 69O-144.007 only apply to property & casualty risks.

Federal reforms

As discussed above, the NRRA is the cornerstone of federal legislation reform in the area of reinsurance and surplus lines. The NRRA was promulgated by Congress as a method to modernize and standardize reinsurance and surplus lines regulation, in much the same way that the NAIC had attempted to do in the years before the NRRA's passage.

The main principle around which the NRRA revolves is that nonadmitted insurance placements, brokers, and insurers should subject to clear rules that are harmonized across the various states. To accomplish these aims, the NRRA requires that only the regulatory requirements of the insured's home state control and prohibits any state other than the home state of an insured from requiring a premium tax incident to a placement. The NRRA also states that only an insured's home state may require licensing of a surplus lines broker in order to conduct nonadmitted insurance business with an insured. Gone would be the days where surplus lines brokers would have to be licensed in every state to make multistate placements. In keeping with the aim of harmonizing requirements across states, § 521 of the NRRA also pushes the states to "adopt nationwide uniform requirements, forms, and procedures, such as an interstate compact, that provide for the reporting, payment, collection, and allocation of premium taxes,"[14] which provides the drive for the SLIMPACT and NIMA compacts. While it was expected that an interstate compact system might have to be in place by July 21, 2011 (the effective date of the NRRA), no compact was in place by such date. It is not clear what the repercussions of this will be or what actions Congress will take to remedy the situation; however, there is currently uncertainty in the market as the myriad of surplus lines brokers follow a muddle of procedures with no central clearinghouse to accept payments or provide guidance.

In furtherance of the above intents of the NRRA, important aspects of the NRRA were limiting the extraterritorial application of states' credit for reinsurance rules and limiting solvency regulation of U.S. reinsurers to the reinsurer's domiciliary state. If the domiciliary state is an NAIC-accredited state (or has substantially similar financial solvency requirements), that state is now sole regulator of the reinsurer's financial solvency and no other state in which the reinsurer conducts business may require it to provide financial information other than that required by the domiciliary state. Notably, the NRRA prohibits a state in which a U.S. ceding insurer is licensed, but not domiciled, from denying credit for reinsurance if the ceding insurer's domestic state recognizes credit for reinsurance for the insurer's ceded risk and is an NAIC-accredited state (or has substantially similar financial solvency requirements).

Captives

There have been many questions of late regarding how recent regulatory change would affect captives. Captives are an important part of the risk strategy of many insurance and noninsurance groups, and therefore, a number of industries outside of insurers are closely watching regulatory reform initiatives. As an increasing number of jurisdictions make plain their intentions to adopt new prudential requirements, captive owners are beginning to evaluate the benefits and drawbacks

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[13] Boyle, Charles E., "Insurance Groups Laud State Regulators' Action to Reduce Reinsurance Collateral," *Insurance Journal*, November 8, 2011 (http://www.insurancejournal.com/news/national/2011/11/08/223334.htm)

[14] http://www.napslo.org/imispublic/PDF/Legreg/NRRAfinal.pdf

of redomestication, while prospective captive owners have become ever more shrewd with respect to the panoply of options available to them for a captive domicile. As with reinsurance and surplus lines issues, the captive market is an international space with U.S. states and foreign jurisdictions such as Barbados, Bermuda, Cayman, and the United Kingdom all vying for captive business.

On the flip side, prospective captive domiciles are working harder to keep and to attract captives to their jurisdictions. Indicative of this trend, many captive domiciles waive premium tax requirements, create brochures touting the benefits of their domiciles, guarantee minimum application turnaround times, and generally make the formation/redomestication process as smooth and easy as possible.

One item of significant concern to the captive sector has been the application of NRRA rules regarding taxation to captives. Captives have generally enjoyed low or no tax rates in the United States on direct premiums written or assumed premiums. This fact, coupled with ceding insurers that can be located in states with no direct procurement tax, makes captives an attractive risk transfer solution from a tax perspective for many groups. The NRRA, in its broad definition of what can be considered a nonadmitted insurer, leaves open to the states the interpretation of captives as nonadmitted insurers which could then insert them into the taxation schemes related to all nonadmitted insurers such as SLIMPACT and NIMA (discussed previously). Even more, there is the potential for states to reassess their lack of independent procurement tax while deciding which of the interstate compacts to join. Various industry observers, however, such as the Vermont Captive Insurance Association, believe captive taxation will not change as a direct result of the NRRA,[15] but rather, could change as a result of a new focus on surplus lines taxation by the states in order to generate badly needed revenue.

Unfortunately, only time will tell in which direction the captive sector will go and which jurisdictions become more or less favored for captive formation/redomestication. However, it would be most prudent for captive owners to continuously be aware of new federal and state laws and interpretations which may affect the captive sector.

Conclusion

As the United States careens down the path of reinsurance and surplus lines regulatory reform, a number of issues are becoming clear. Regulatory uncertainty as to both the practical application of already promulgated regulations and the future promulgation of new requirements is a significant risk for all entities in the nonadmitted market. The cost of this uncertainty will be borne by companies through inefficient allocation of resources either in over- or undercompliance, and also likely through the payment of fines and remediation procedures due to noncompliance.

It is imperative for companies to closely watch regulatory developments and provide ample lead time for any required changes in order for the company to get into compliance. Those who wait until the last moment may find themselves deluged by the countless new regulatory requirements coming down the road. At best, those companies may risk costly compliance exercises due to compressed time lines and resource overburdening. At worse, they may find themselves the targets of regulatory action. Given that many companies already feel overburdened by the costs, stresses, and uncertainties of regulatory compliance in the current environment, those who have underestimated or discounted the effect of regulatory change on their nonadmitted business should immediately conduct audits to understand the company's current compliance state, the requirements related to future state compliance, and how to bridge the two.

[15] Beckett, Vicky, "Dodd Frank does not apply to captive surplus lines says VCIA," *Captive Review*, October 14, 2011 (http://www.vermontcaptive.com/assets/files/Captive%20Review%20Mag%20Oct%202011%20Dodd%20Frank.pdf)

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