

FIT Briefing

An Update from the Financial Integration Team

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Update on NAIC Proposal to Change Current Collateral Requirements

The National Association of Insurance Commissioners (NAIC) is considering a proposal that would change the existing regulatory framework for reinsurance collateral requirements for both authorized and unauthorized reinsurers. This briefing provides an overview of the proposal and discusses issues related to implementation.

Background

At its December 2006 meeting, the NAIC Reinsurance Task Force voted to recommend an overhaul of the current regulatory structure and the creation of a new Reinsurance Evaluation Office (REO), which would replace the current 100 percent collateralization requirement for unauthorized reinsurers and reinsurers that have opted to maintain trusts in the United States (e.g., Lloyd's). In addition, U.S. licensed and accredited reinsurers would be required to post collateral unless they met certain standards. State insurance regulators, through the REO, would establish procedures to evaluate the financial strength and operating integrity of reinsurers and, based on the outcome of the evaluation, issue a new rating for each reinsurer that participates in this program.

The proposed regulatory changes are clearly a long way from implementation. It is very early in the process, and no one has addressed the practical considerations, including enactment of legislation by 50 state legislatures that would in essence cede/share some of their authority. Also, there are questions as to whether the state regulators could delegate authority as they would have to defer to the NAIC, which would defer to the REO, which would rely largely upon the work of rating agencies. September 2007 has been set as the date that refinements to the new ratings proposal are due; however, many difficult issues must be addressed for the NAIC to come up with commercially reasonable means of implementing the new regime by that time.

Proposed Categories

The latest draft proposal now has six rating categories with a REO 1 rating carrying no collateral requirement, as compared to the 20 percent minimum requirement in an earlier proposal. Another important change from the earlier proposal is that no collateral would be required for inter-affiliate reinsurance assumptions by U.S. licensed or accredited reinsurers, including inter-company pooling arrangements.

Based on the financial information submitted, the REO will consider the credit ratings set forth in the table on the next page. If the ratings are inconsistent, the REO will look to the majority of ratings; however, a rating awarded by the REO may be higher or lower than those awarded by other rating agencies if the REO believes it is appropriate.

Band	A.M. Best Rating	S&P Rating	Moody's Rating	Fitch Rating	Collateral Required	U.S. Only (2)
REO 1	A++	AAA	Aaa	AAA	none	none
REO 2	A+	AA+, AA, AA-	Aa1, Aa2, Aa3	AA+, AA, AA-	20%	none
REO 3	A, A-	A+, A, A-	A1, A2, A3	A+, A, A-	40%	none
REO 4	B++, B+	BBB+, BBB, BBB-	Baa1, Baa2, Baa3	BBB+, BBB, BBB	60%	
REO 5	B, B-, C++, C+	BB+ to B-	Ba1, Ba2, Ba3, B1, B2, B3	BB+, BB, BB-, B+, B, B-	80% (1)	
REO 6	C to F	CCC, D,R, NR	Caa, Ca, C	CCC+, CCC, CCC-, DD	100% or higher	

- (1) It is not clear at this point whether the REO-5 level companies will be required to post 80 percent or 100 percent collateral.
- (2) U.S. reinsurers rated REO 1, 2 or 3 will not have to post collateral for unaffiliated business if they meet certain other capital and minimum financial strength requirements and have a history of promptly paying claims.

NAIC Consideration

The vote was 15 - 5 in favor of proceeding with this proposal. Alabama, California, District of Columbia, Florida, Georgia, Illinois, Kentucky, Maine, New Hampshire, New York, North Dakota, Pennsylvania, Puerto Rico, Texas and Virginia voted for the proposal. Connecticut, Minnesota, Nevada, Washington and Wisconsin voted against the proposal. New Jersey and Delaware were not present and did not vote. There is some discussion among insiders that the vote may not signal a long-term commitment to the complete overhaul of the current process, but may be the result of pressures to address foreign trade issues. However, such discussion is speculation at this point.

There was intense debate among regulators and interested industry representatives, and there is currently no consensus about the appropriateness of a ratings-based approach. Many, but not all, ceding companies are opposed to any change that might adversely impact collectibility, and many of the U.S. reinsurers also oppose it, having spent a great deal of money on licensing or accreditation. In addition, some regulators and cedants are concerned about a cedant's ability to enforce judgments against non-paying reinsurers domiciled outside the United States that no longer post collateral.

Conclusion

It is likely that the proposed new framework will be debated vigorously by the industry and will be revisited by regulators at the NAIC and at the individual state level before it is enacted by state legislatures. There is no consensus among either regulators or the industry on how to proceed, and we are a long way from changing current practice. In the coming months, Guy Carpenter will continue to monitor this important development and communicate updates as necessary.

This briefing was prepared by Guy Carpenter colleagues listed below who follow the NAIC. Please contact one of them if you have a question or require additional information.

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