TESTIMONY OF FRANKLIN W. NUTTER, PRESIDENT
REINSURANCE ASSOCIATION OF AMERICA

INSURANCE REGULATION AND
COMPETITION FOR THE 21ST CENTURY

BEFORE THE CAPITAL MARKETS, INSURANCE AND
GOVERNMENT SPONSORED ENTERPRISES SUBCOMMITTEE
HOUSE COMMITTEE ON FINANCIAL SERVICES

June 11, 2002

CHAIRMAN BAKER AND MEMBERS OF THE COMMITTEE:

My name is Franklin W. Nutter and I am president of the Reinsurance Association of America (RAA). The RAA is the nation's leading trade association representing the US property/casualty reinsurance industry. RAA members are licensed, authorized or accredited in all US jurisdictions. I am pleased to appear before you today to address reinsurance matters, particularly those regulatory matters that affect the competitiveness of the US reinsurance industry in this very global marketplace. I am not here today to advocate one system of regulation over another, but instead, as you requested, to point out several issues of great importance to US reinsurers and to give you our views on how those issues should be addressed, regardless of the regulatory method that is employed. The issues I plan to address are credit for reinsurance, extraterritorial application of state laws, mutual recognition and insurance receiverships.

I. BACKGROUND ON REINSURANCE

a. The US Reinsurance Market

Before I begin with my remarks about those issues, I want to provide you with a brief overview of the reinsurance market and how reinsurance regulation is conducted in the United States.

Reinsurance is a transaction in which one insurance company indemnifies, for a premium, another insurance company against all or part of the loss that it may sustain under its policy or policies of insurance. The insurance company purchasing reinsurance is known as the ceding insurer; the company selling reinsurance is known as the assuming insurer, or, more simply, the reinsurer. Described as the "insurance of insurance companies," reinsurance provides reimbursement to the ceding insurer for losses covered by the reinsurance agreement. The fundamental objective of insurance, to spread the risk so that no single entity finds itself saddled with a financial burden beyond its ability to pay, is enhanced by reinsurance.

Reinsurance is a key component of the insurance marketplace, reducing the volatility experienced by insurers and improving insurers' financial performance and security. It is widely recognized that reinsurance performs at least four primary functions in the marketplace: to limit liability on specific risks; to stabilize loss experience; to protect against catastrophes; and to increase insurance capacity.

The increasingly important role that reinsurance plays in the insurance marketplace cannot be over-emphasized. Industry statistics show that the net reinsurance recoverables on all paid and unpaid property/casualty losses in 2000 represent approximately 144.2 percent of the surplus of US property/casualty insurers.[1]

Reinsurance is a global business which can be best illustrated by the number of reinsurers assuming risk from US cedents. In year 2000 more than 3,300 foreign reinsurers assumed business from US ceding insurers. Those reinsurers were domiciled in more than 100 foreign jurisdictions[2]

b. US Reinsurance Regulation – Direct and Indirect

The US employs two methods of reinsurance regulation, both direct regulation and indirect regulation.

Direct regulation is imposed on those reinsurers that opt to be licensed in the US. Reinsurers licensed in at least one US jurisdiction are subject to the full spectrum of laws and regulations to which a primary insurer is subject. The exceptions to this general rule are rates and forms. Because reinsurance is conducted between sophisticated parties of essentially equal bargaining power, regulators do not impose regulatory requirements relating to the rates that can be charged for reinsurance or the forms that can be used to evidence the contractual terms.

US licensed reinsurers are subjected to regulation that requires, among other matters, the following:

- Minimum Capital and Surplus Requirements
- Risk-Based Capital Requirements
- Investment Restrictions

[1] BEST'S AGGREGATES & AVERAGES PROPERTY-CASUALTY UNITED STATES (A.M Best Co., ed. 2001); According to the NAIC Annual Statement Instructions for Property/Casualty insurers, property/casualty lines of business, include: fire, allied, farmowners 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' 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.

[2] REINSURANCE ASSOCIATION OF AMERICA (RAA), ALIEN REINSURANCE IN THE US MARKET 2000 DATA (2000), at 3.

- Disclosure of Material Transactions
- Licensing (fit and proper) Requirements
- Disclosures/Prohibitions on Certain Fronting Transactions
- Obligations/Prohibitions with Respect to Reinsurance Intermediaries
- Asset Valuation & Requirements
- Examinations of the Reinsurer
- Insurance Holding Company Requirements
- Fraud Prevention
- Annual Statement Mandated Disclosures, Accounting and Filings
- Credit for Reinsurance
- Unfair Trade Practices
- Annual Independent Auditor's Reports
- Actuarial-Certified Loss Reserve Opinions
- Restrictions on Assumption Reinsurance Transactions

Recognizing that an insurance marketplace as large as that found in the US is in need of a substantial amount of reinsurance capacity, US regulators do not prohibit non-US reinsurers from assuming reinsurance business in the US, nor do they presume to have the regulatory capability or resources to assess the financial strength or claims paying ability of non-US reinsurers.

Instead, the US has developed a system of indirect regulation whereby the reinsurance transaction is regulated through the credit for reinsurance mechanism. Credit for reinsurance is the financial statement accounting effect given to a ceding insurer if cessions are ceded in accordance with prescribed criteria. If the criteria are met, the ceding insurer may record a reduction in insurance liabilities for the effect of the reinsurance transactions. The fundamental concept underlying the US regulatory view is that a reinsurer must either be licensed and subject to the full spectrum of reinsurance regulation or provide collateral to ensure the payment of the reinsurer's obligations to US ceding insurers.

In taking this regulatory approach, the US has created a very open but secure marketplace. The system is also grounded on a level playing field. All options for doing business in the United States whether it is through licensing, accreditation, multiple or single beneficiary collateralization – are open to all reinsurers whether they are domiciled in the US or elsewhere in the world.[3]

II. KEY ISSUES FOR THE US REINSURANCE INDUSTRY

There are a number of important elements about reinsurance regulation with which RAA members are concerned. I will address a few of them today.

a. Credit for Reinsurance

US laws providing for the circumstances under which ceding insurers may take financial statement credit are the cornerstone of US reinsurance regulation. Those laws are based in substantial part[4] on the NAIC model law and regulation governing credit for reinsurance.[5]

The NAIC model law and regulation have been the subject of debate in recent years. Non-US trade associations are currently advocating the reduction of collateral for those reinsurers that choose not to be subjected to US reinsurance regulation. Advocates of this reduced security claim that US collateral requirements impede competition and are unnecessary in a world that is becoming more global. The RAA and US primary insurers have opposed this effort at weakening US regulation and diluting the financial security of US insurers and their policyholders.

---

[3] US credit for reinsurance laws provide a number of options for non-US reinsurers that seek to assume reinsurance risk from US ceding insurers. A non-US reinsurer may:

1. Obtain a license to conduct insurance/reinsurance in the US by establishing a separate affiliate entity or by directly "entering" the US through a particular state and establishing a branch in the US;

2. Establish a multiple beneficiary trust which secures its obligations to all US cedents plus a surplus amount which is, for an individual assuming insurer, US $20 million (for Lloyd's the joint and several surplus amount is US $100 million); or

3. 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.

[4] There are significant deviations among the states, particularly in the area of extraterritorial application of state laws as discussed in subsection b. of this section.

[5] CREDIT FOR REINSURANCE MODEL LAW, Vol.-785 (National Association of Insurance Commissioners 1996) and CREDIT FOR REINSURANCE MODEL REGULATION, V-786 (National Association of Insurance Commissioners 1996).

As the world's largest insurance marketplace, the US is dependent on non-US as well as US reinsurance capacity. At the same time, US regulators cannot be expected to know, or to learn, the intricacies of accounting systems and regulatory schemes used throughout the world to determine the financial strength of non-US reinsurers. Because the ceding insurer is allowed financial statement credit for cessions to such non-US reinsurers, it is imperative that US regulators have the confidence that the non-US reinsurer is able and willing to pay its obligations to US ceding insurers as they become due. This is accomplished through the collateralization of the reinsurer's obligations. Collateralization eliminates the regulator's need to assess the level of regulation in the non-US reinsurer's domiciliary jurisdiction or the financial strength of the particular reinsurer. Collateralization ensures that funds are available to satisfy the non-US reinsurer's obligations whether it is solvent or not.

Non-US reinsurers have all the options available to them for doing business as do US domiciled reinsurers. In taking this approach, the US has struck a proper balance between creating and maintaining an open marketplace while ensuring the financial security of ceding insurers and their policyholders. It is difficult to comprehend how the US system impedes competition when one considers the number of non-US reinsurers that assume business from US insurers.[6]

The RAA believes that it is essential to maintain the strong regulatory structure that has been created in the US. The NAIC model and regulation for credit for reinsurance represents a minimum regulatory threshold for protecting the financial interests of US insurers and their policyholders. This minimum threshold should be maintained if not improved as the states work on improving their regulatory environment. If Congress were to consider an optional federal charter, the RAA

[6] *See* RAA, *supra,* note 2, at 3 and 14. US reinsurance companies accounted for 53.4 percent of the US premium written in 2000, while non-US companies accounted for 46.6 percent.

would urge Congress to incorporate a strong credit for reinsurance regulatory system similar to the NAIC model and regulation.

b. Extraterritorial Application of Law

The RAA recognizes the need for greater efficiency in the regulation of reinsurance. As a result of our 50-state system of regulation, significant differences have emerged among the states with respect to reinsurance regulatory requirements. The cost associated with addressing these deviations among the states, in addition to the basic expense of a multi-state system, add extra costs to transactions that are ultimately reflected in the premiums paid by consumers. While the NAIC and state regulators are to be applauded for their efforts toward greater uniformity in the adoption of model laws and regulations and the creation of the accreditation system, this has not prevented states from pursuing varying and sometimes inconsistent regulatory approaches. One of the best examples of this phenomenon is the extraterritorial application of state laws.

Approximately 14 states apply at least some of their regulatory laws on an extraterritorial basis, meaning that the state law not only applies to the insurers domiciled in that state but to insurers domiciled in other states if the extraterritorial state has granted a license to the insurer. Many insurers and reinsurers are licensed in all states. An insurer domiciled in a state other than New York but licensed in New York will find that New York law applies to the way it conducts its business nationwide. This extraterritorial application of state law results in inconsistencies among state laws.

States applying at least some of their laws extraterritorially include: California, Colorado, Florida, Kentucky, Maryland, Michigan, New Jersey, New Mexico, New York, Oregon, Pennsylvania, Texas, Utah and West Virginia.

As Congress proceeds in reviewing the current regulatory structure and considering a new one for the future, we should focus on streamlining reinsurance regulation to be more competitive in the global marketplace. Any structure that is adopted should eliminate duplicative and inconsistent regulation like that which is caused by the extraterritorial application of state laws.

c. Mutual Recognition

As I have previously mentioned, reinsurance is a global business. It has long been recognized that the level of reinsurance regulation varies substantially in countries throughout the world. The United States, which imposes a very highly structured level of regulation upon licensed reinsurers stands in stark contrast to countries like Belgium where reinsurers are subject to no direct reinsurance supervision and Greece where reinsurers are subject to no supervision whatsoever.[7]

While some countries impose what has been characterized as "equal or nearly equal treatment" of "professional" reinsurers[8] and direct insurers,[9] other countries employ a "reduced regime" of direct supervision,[10] and still others combine some elements of direct supervision with indirect supervision.[11] This summary of the level of reinsurance regulation was derived from the results of a questionnaire submitted by the EU Commission to member countries and published in 1999.[12] As noted by other commentators, the results not only reflect the diversity of reinsurance

---

7 GESAMTVERBAND DER DEUTSCHEN VERSICHERUNGSWIRTSCHAFT & BRITISH INSURERS' INTERNATIONAL COMMITTEE, DRAFT FRAMWORK FOR A EUROPEAN REGIME FOR THE SUPERVISION OF CROSS-BORDER REINSURANCE, at Enclosure A (1999).

8 The term "professional reinsurers" is used here only for clarity since the term has been used in the references cited. It is not typically used in the U.S.

9 Denmark, United Kingdom, Finland and Portugal. *See* GESAMTVERBAND DER DEUTSCHEN VERSICHERUNGSWIRTSCHAFT & BRITISH INSURERS' INTERNATIONAL COMMITTEE, *supra,* note 5.

10 *Id*. Austria, Italy, Spain and Sweden.

11 *See id.* Germany, France and the Netherlands.

12 *Id.,* at 2.

regulation in the EU alone, but the fact that there is no globally recognized method of conducting reinsurance regulation.[13]

There is an effort underway in several forums, including the NAIC, IAIS,[14] and through the WTO financial services negotiations, to create a system of mutual recognition among countries. This effort, led by European trade associations, seeks to establish a system where a country recognizes the reinsurance regulatory system of other countries and allows reinsurers to conduct business without the additional imposition of regulatory requirements. If such a system were established, European reinsurers would be permitted to assume reinsurance risk in the US without having to obtain a US license and without having to provide collateral for their liabilities to US ceding insurers. This would be the result even if the European reinsurer was domiciled in a country with far less reinsurance regulation than that which is imposed by US regulators on US licensed reinsurers.

The RAA has challenged this effort for several reasons. Although US reinsurers recognize the value of a more efficient reinsurance regulatory system, mutual recognition cannot be accomplished on a worldwide basis, or even a regional basis, until certain other events occur.

First, there needs to be created and implemented, an international accounting system, which provides more transparency between different existing systems. That effort, though underway, is years from becoming a reality.

[13] *Id*.

[14] The IAIS is the International Association of Insurance Supervisors which is comprised of insurance regulators from over 100 jurisdictions.

Second, there must first be mutual recognition among the states within the US. It makes no sense whatsoever for regulators to place trust and confidence in the regulatory systems of foreign jurisdictions before and until they afford that trust and confidence to their counterparts in the US.

Third, there needs to be established a predictable and consistent method for the recognition and enforcement of US judgments abroad. The RAA recently submitted a paper to the NAIC on this subject which demonstrates that while the US regularly recognizes and enforces the judgments rendered in other nations, US judgments are often not given reciprocal treatment. The US is not a party to any treaty for the recognition and enforcement of judgments and some European countries refuse to recognize or enforce judgments with such jurisdictions. Other European countries refuse to enforce punitive damages and treble damages while still others review the fairness of compensatory damages in light of their own public policy.

And finally, any level of foreign regulation, which is mutually recognized by the US, must become the new cap for the level of regulation imposed by US regulators on US licensed reinsurers. There is no legitimate rationale for imposing a higher level of regulation on US reinsurers than that which US regulators are prepared to accept from those who are regulated abroad.

There are differences in the insurance markets throughout the world. In some countries, there are only a few companies that assume reinsurance risk while thousands of reinsurers assume reinsurance risk ceded by US insurers.[15] While the RAA does not seek to export the US reinsurance system to those countries where few reinsurers assume risk, it does advocate the

[15] See RAA, *supra*, note 2, at 3 and 14. While more than 3,300 non-US reinsurers assumed risk in 2000, those reinsurers accounted for less than half of the reinsurance premium written that year.

need for substantially the same level of regulation to be imposed if those reinsurers want to assume business from the US on a mutual recognition basis.

d. Receivership

Insurance companies, like any other commercial enterprise, are subject to financial failure. Unlike individuals and many commercial entities, insurance companies are not subject to US bankruptcy laws. Instead, insurance company receiverships are administered on a state-by-state basis. While the nature of insurance companies that become insolvent has changed over the years, state receivership laws have failed to keep up with those changes and are now generally outdated and inadequate to handle the administration of large sophisticated entities.

Most state receivership laws are based on prior NAIC models and attempts to update state laws with the current NAIC model have failed. The reason for those failures is due, in large part, to the controversial nature of the model and circumstances under which it was drafted and adopted. Therefore, the outlook for improving state receivership laws through adoption of the current NAIC model law is bleak.

Reinsurers are keenly interested in receivership laws because reinsurance recoverables are oftentimes the largest asset in the estate of an insolvent insurer. Issues such as priority, setoff, arbitration, cut-throughs, insolvency clauses, claim estimation/acceleration, and voidable preferences dominate the litigation involving reinsurers and insolvent estates. State laws with respect to the matters are both deficient and inconsistent.

Several years ago, the Insurance Receivership Interstate Compact Commission appointed a group of receivership experts from state insurance departments, guaranty associations, and the insurance and reinsurance industry in an effort to develop a better quality and more balanced receivership law. That effort resulted in the Uniform Receivership Law (URL), which has the support of a number of regulators, receivers and industry associations.

The RAA supports the creation of a uniform national receivership system to replace the current system. The administration of impaired and insolvent insurance companies should be fast, efficient and predictable. Toward this end, the RAA supports the adoption of the URL on a national basis and believes it represents the best chance that we have for achieving the uniformity, equity and predictability that creditors are entitled to expect and receive from government.

III. CONCLUSION

The world is changing--at a fast pace. The way in which reinsurers do business is changing, the products and services they offer is evolving, the range and characteristics of their competitors and their clients is expanding. Reinsurers have been in the forefront in anticipating these changes and in advocating greater regulatory efficiencies to expand their opportunities in a global marketplace.

Technology, global events, convergence of financial markets combine to offer regulators the opportunity to effect fundamental change to the insurance and reinsurance regulatory regimes that have existed in the past. However, this opportunity carries with it the burden of ensuring that the critical balance between efficiency and financial security is reached.

The United States has an open reinsurance marketplace, as illustrated by the substantial participation of non-US reinsurers. At the same time it is a highly regulated environment that places solvency first and foremost, including the collectability of reinsurance recoverables.

The RAA has long been an advocate for strong reinsurance regulation. US reinsurers have seen the problems of past insolvencies when weak players entered and exited the marketplace, leaving the stronger reinsurers with harsher regulation imposed on them in an attempt by regulators to avoid a repetition of past mistakes. That stronger regulation is accompanied by a higher cost of doing business which is borne not by the weak players that exited the market but by the long-term players that were not the cause of the problem in the first instance. Strong reinsurance regulation is at best a deterrent to the entry of such marginal reinsurers in the marketplace and, at worst, a means of detecting the weak players at an earlier stage.

Ceding company clients suffer from the absence of strong reinsurance regulation.[16] To the extent that reinsurance recoveries are unavailable due to the reinsurer's insolvency, or such recoveries are made less efficiently and more expensively, guaranty associations are unable to recoup the funding they provide to policyholders and claimants. The primary insurance industry bears that loss and the cost of business is increased, resulting in higher costs to the consumer.

The RAA is not here today to advocate one regulatory structure over another. We urge the Subcommittee to consider, in its deliberations, the importance of maintaining strong regulation through credit for reinsurance laws, proceeding cautiously toward mutual recognition, improving the insurance receivership process, and eliminating duplicative and inconsistent reinsurance regulation. There are a number of alternatives available for the future structure of insurance and reinsurance regulation, but regardless of the method pursued, it is incumbent upon us to ensure that the critical balance between efficiency and financial security is maintained.

The RAA thanks Chairman Baker and the Subcommittee for this opportunity to comment on insurance regulation and competition in the 21st century, and we look forward to working with all Members of the House Financial Services Committee as the Committee considers this most important issue.

---

[16] Insolvencies in the US are administered by the insurance departments and, to a large extent, policyholders and claimants are paid by guaranty associations. Guaranty associations are funded by the solvent insurance industry.