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TESTIMONY

OF

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ADDITIONAL PERSPECTIVES ON THE NEED FOR INSURANCE REGULATORY REFORM

BEFORE

FINANCIAL SERVICES SUBCOMMITTEE
ON
CAPITAL MARKETS, INSURANCE AND GOVERNMENT SPONSORED ENTERPRISES

October 30, 2007

My name is Frank Nutter and I am President of the Reinsurance Association of America (RAA). The RAA is a national trade association representing property and casualty companies that specialize in assuming reinsurance. RAA members are licensed, authorized or accredited in all US jurisdictions. Together, RAA members and their affiliates write nearly two-thirds of the reinsurance coverage provided by U.S. property and casualty reinsurers.

I am pleased to appear before you today to provide the reinsurance industry's perspective on the need for insurance reform. I want to commend Chairman Kanjorski and Ranking Member Pryce for their continued leadership in the area of insurance regulatory reform. I welcome the opportunity to address the committee on why the 50-state system for regulating the reinsurance marketplace is in need of reform, particularly in those regulatory areas that affect the ability of the US reinsurance industry to compete in this very global marketplace and attract much needed capacity to the United States. Requiring large international companies conducting highly sophisticated commercial transactions to submit to a 50-state regulatory system is unnecessary. My testimony will highlight how US and foreign reinsurers doing business in the United states are regulated; why the 50-state insurance regulatory system does not work well for the sophisticated global marketplace; and explain RAA's position in support of an optional federal charter for the reinsurance industry or alternatively, federal legislation that streamlines the current state system.

I. BACKGROUND ON REINSURANCE

a. The US Reinsurance Market

Reinsurance is critical to the insurance marketplace. It reduces the volatility experienced by insurers and improves 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 provide transfer for insurers of major natural and man-made catastrophe risk; and to increase insurance capacity.

I cannot emphasize enough the important role that reinsurance plays in the insurance marketplace. For example, after virtually every major US catastrophe during the past century, reinsurers have assisted in the recovery of insured losses. For natural disasters, typically one-third of the insured losses are passed on to reinsurers; and in the events of September 11, two-thirds of the losses were absorbed by the reinsurance industry. Fifty percent of the 2005 losses associated with Hurricanes Katrina, Rita and Wilma were ultimately borne by reinsurers.

Reinsurance is a global business. This can be best illustrated by the number of reinsurers assuming risk from US cedents. In 2006, more than 2,300 foreign reinsurers assumed business from US ceding insurers. Although most insurers principally engaged as assuming reinsurers are located in a small number of countries, the 2300 reinsurers identified by US ceding insurers were domiciled in more than 95 foreign jurisdictions[1]. Their share of the US market underwritten directly by foreign-based reinsurers has grown steadily to 53% in 2006 from 38% in 1997.

Some foreign reinsurers also establish US subsidiaries. If the amount of US based ceded revenue to these foreign controlled entities were added to the percentages I quoted above, the total non-US share would be 85%. However, these percentages should not be misconstrued.

[1] Reinsurance Association of America (RAA), Offshore Reinsurance in the US Market 2005 Data (2006).

Non-US based reinsurers and their US subsidiaries bring much needed capital and capacity to support the extraordinary risk exposure in the US and to spread that risk throughout the world's capital and capacity providers.

b. US Reinsurance Regulation – Direct and Indirect

The US employs two methods of reinsurance regulation: direct regulation of licensed US reinsurers and indirect regulation of the reinsurance transaction ceded by US insurers to unauthorized reinsurers.

States directly regulate reinsurers that are licensed in the US. Although 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, reinsurers licensed in at least one US state are subject to the full spectrum of solvency laws and regulations to which a primary insurer is subject.

To fulfill the larger demands of the US-market, there is a need for substantial reinsurance capacity. As a result, US regulators do not prohibit non-US reinsurers from assuming reinsurance business in the US, nor does the system presume that they 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 system is that a reinsurer must either be licensed and subject to the full spectrum of multi-state reinsurance regulation, or provide collateral to ensure the payment of the reinsurer's obligations to US ceding insurers.

Capital providers to the reinsurance market in recent years have clearly opted for the later approach to avoid the multi-state licensing approach. Following the 1992 hurricane season, eight new reinsurers were formed reflecting $4 billion of new capital. Following the events of September 11, 2001, 12 new reinsurers with $10.6 billion capital were formed. After Hurricane Katrina, at least 38 new reinsurance entities with $17 billion of new capital were formed. Nearly all of the new capital came from US capital markets. However, other than the US subsidiaries of some of these new companies, no new US-domiciled reinsurer has been formed since at least 1992. For these startups, the ease of establishment, capital formation, and regulatory approvals in non-US jurisdictions contrasted with the cumbersome and protracted nature of getting licensed in multiple US states.

II. KEY ISSUES FOR THE US REINSURANCE INDUSTRY

The Reinsurance Association of America seeks to change the current regulatory structure, and advocates a modified optional federal charter for reinsurance to allow a reinsurer to choose between a single federal regulator or remain in the current 50-state system. Alternatively, the RAA seeks federal legislation that streamlines the current state based system. There are a number of key problems and inefficiencies with the current state framework for reinsurance regulation, which has led the RAA Board to pursue a federal role.

a. Credit for Reinsurance

US state laws providing for the circumstances under which ceding insurers may take financial statement credit are the cornerstone of state reinsurance regulation. While there are differences among the states, those laws are based in substantial part[2] on the NAIC model law and regulation governing credit for reinsurance.[3]

The NAIC model law and regulation has been the subject of much debate in recent years. Some non-US reinsurers have advocated the reduction of collateral for those reinsurers that choose not to be subject to direct US licensing and reinsurance regulation. Advocates of this reduced security represent that US collateral requirements impede competition and are unnecessary in a business that is becoming increasingly global. US primary insurers have opposed this effort, contending it weakens US regulation and dilutes the financial security of US insurers and their policyholders.

While non-US reinsurers have the option of being licensed to do business in the US, state regulation has attempted to strike a balance between creating and maintaining an open marketplace, while ensuring the financial security of ceding insurers and their policyholders. As the world's largest insurance marketplace, the US is dependent on non-US and US reinsurance capacity. At the same time, 50 state 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. The ceding US insurer is allowed financial statement credit for cessions to such non-US reinsurers, based on state laws that require 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

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[2] There are significant deviations among the states, particularly in the area of extra-territorial application of state laws as discussed below.
[3] 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).

strength of the particular reinsurer. It also reflects the challenges facing 50 state regulators with resource constraints and competing regulatory demands. Unfortunately, initiatives by some states suggest the risk of a patchwork of state laws relating to financial security may be emerging.

The RAA believes that it is essential to maintain a strong, but uniform, regulatory structure in the US. In that regard, the RAA commends the sponsors of HR 3200 for proposing an optional federal charter for insurers. In large part, this will address the RAA's concerns over uniformity of applicable law.

As the Committee proceeds, we urge it to incorporate a strong credit for reinsurance regulatory system, one that reflects and supports reinsurers need for global capital and risk management.

b. Extra-Territorial Application of Law

The RAA believes there is a 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 differences among the states, in addition to the basic expense of multi-state systems add extra costs to transactions, and these 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 is the extra-territorial application of state laws.

Thirteen states apply at least some of their regulatory laws on an extra-territorial 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 extra-territorial state has granted a license to the insurer. For example, for an insurer domiciled in a state other than New York, but licensed in New York, it will find that New York asserts that its laws apply to the way it conducts its business nationwide. Since most US based reinsurers are licensed in all 50 states, this extra-territorial application of state law results in inconsistencies among state laws. States applying at least some of their laws extra-territorially include: California, Florida, Kentucky, Maryland, Michigan, New Jersey, New Mexico, New York, Pennsylvania, Texas, Utah, Virginia and West Virginia.

As Congress proceeds to review the current regulatory structure and consider a new one for the future, we encourage the Committee to 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 extra-territorial application of state laws.

c. Mutual Recognition

US states impose a highly structured and conservative level of regulation upon licensed reinsurers. However, it has long been recognized that the level of reinsurance regulation varies substantially in countries throughout the world.

While some countries impose what has been characterized as "equal or nearly equal treatment" of "professional" reinsurers[4] and direct insurers,[5] other countries employ a "reduced regime" of direct supervision.[6] And still others combine some elements of direct supervision

[4] The term "professional reinsurers" is used here only for clarity. It is not typically used in the U.S.
[5] Denmark, United Kingdom, Finland and Portugal.
[6] Id. Austria, Italy, Spain and Sweden.

with indirect supervision.[7] There are several globally recognized methods of conducting reinsurance regulation.[8]

The RAA is encouraged by the inclusion in HR 3200 of a system of mutual recognition among countries. Mutual recognition seeks to establish a system where a country recognizes the reinsurance regulatory system of other countries and allows reinsurers to conduct business based on the regulatory requirements of its home jurisdiction. If such a system were established, European reinsurers would be permitted, for example, to assume reinsurance risk from the US without having to obtain a US license and without having a requirement in law to provide collateral for their liabilities to US ceding insurers. In return, such a system would allow US reinsurers to conduct business in the mutually recognized country based on its US regulatory oversight.

A single national regulator with statutory authority could negotiate an agreement with the regulatory systems of foreign jurisdictions that can achieve a level of trust and confidence to their counterparts in the US. The foreign regulatory regime need not be identical to the US regulatory system, but one that has substantially equivalent standards and regulatory enforcement.

III. CONCLUSION

The way in which reinsurers do business in the US is changing; the products and services they offer is evolving, and the range and characteristics of their competitors and their clients is expanding. Reinsurers have been in the forefront of advocating greater regulatory efficiencies to expand capacity in a global marketplace.

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[7] See id. Germany, France and the Netherlands.
[8] Id.

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

The goals of effective reinsurance regulation in the United States should be to promote:

1. Financially secure reinsurance recoverables and capacity that protects the solvency of US ceding insurers.
2. A competitive and healthy reinsurance market that provides sufficient capacity to meet ceding companies' risk management needs.
3. Effective and efficient national reinsurance regulation.

The core characteristics of an appropriate reinsurance regulatory structure that would assist in achieving these goals should include:

1. A single regulator or regulatory system for reinsurance with national regulatory oversight and the power to preempt conflicting or inconsistent state laws and regulations in an effective and efficient manner.
2. The single regulator's authority should provide for the recognition of substantially equivalent regulatory standards and enforcement in other competent regulatory jurisdictions.
3. The regulatory structure should support global capital and risk management, taking into account capital adequacy, assessment of internal controls, recognition of qualified internal capital models and effective corporate governance.
4. The regulatory structure should provide for financial transparency that encourages and supports the cedents' ability to assess counter-party credit risk, including

information regarding the reinsurer's financial condition and the reinsurer's performance in paying covered claims.

5. Regulators should have access to all necessary financial information with appropriate provision for the confidentiality of that information, as provided for currently under state law and regulatory practice.
6. The regulatory structure should have an effective transition mechanism between the current system and any future regime that is consistent with these core characteristics. Absent mutual agreement of the parties, any reduction in existing collateral requirements should only apply prospectively.
7. The regulatory structure should utilize principles-based regulation where appropriate.

Changes to the current reinsurance regulatory structure that meet these goals and core characteristics, include but are not limited to: (1) a single state passport system which allows a reinsurer to be licensed in and regulated by one state but with the ability to then "passport" and assume business in all the other states; or (2) an optional federal charter which allows a reinsurer to remain in the 50-state system or obtain a federal charter and be regulated at the federal level pursuant to federal standards; or (3) a modified optional federal charter which allows a reinsurer to choose between a single federal regulator, a single state regulator or remain in the current 50-state system. The RAA has a strong preference for a modified optional federal charter. Whatever structure is pursued, it will be important to preserve the value of the reinsurers' state licenses and to retain the reinsurers' options to move between various regulatory structures.

The RAA thanks Chairman Kanjorski and the Subcommittee for this opportunity to comment on reinsurance regulation and HR 3200, and looks forward to working with all

Members of the House Financial Services Committee as the Committee considers this most important issue.