



STATEMENT

TESTIMONY

OF

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

**COMMERCIAL INSURANCE
MODERNIZATION**

BEFORE

**THE SUBCOMMITTEE ON CAPITAL
MARKETS, INSURANCE, AND GOVERNMENT
SPONSORED ENTERPRISES**

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My name is Frank Nutter and I am President of the Reinsurance Association of America. It is an honor to appear before you on behalf of the RAA. The RAA is a national trade association representing property and casualty organizations that specialize in reinsurance. The RAA membership is diverse, including U.S. companies and U.S. subsidiaries of foreign companies. Together, RAA members underwrite nearly 2/3 of the gross reinsurance coverage provided by U.S. property and casualty reinsurers and affiliates.

I am pleased to testify today on “H.R. 5637, legislation to streamline the regulation of nonadmitted insurance and reinsurance.” The RAA supports the principles set forth in the legislation and will highlight the key provisions that will help modernize and make reinsurance regulation more efficient. My testimony will address: 1) the reinsurance role in the marketplace, 2) U.S. reinsurance regulation, 3) the extra-territorial application of state law provision, 4) the solvency regulation provision and 5) the credit for reinsurance provision.

Reinsurance Role in the Marketplace:

Reinsurance is a transaction by which one insurance company indemnifies, for a premium, another insurance company against all or part of the loss that it may sustain under its policies of insurance. The insurance company purchasing the reinsurance is known as the ceding insurer; the company selling reinsurance is known as the assuming insurer, or, more simply, the reinsurer. Described as insurance for insurance companies, reinsurance provides reimbursement to the ceding insurer for losses covered in the reinsurance agreement. Reinsurance is a contract between sophisticated parties; there is

no consumer element to the reinsurance transaction. The fundamental objective of insurance, to spread 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 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. Although considerably smaller than the U.S. insurance industry in premiums and capital, the global reinsurance industry has significantly responded to virtually every major U.S. catastrophe over the past century. For natural disasters typically one-third to one-half of the insured losses are passed on to reinsurers; in the events of September 11, 2001, two-thirds of the losses were absorbed by the global reinsurance industry.

U.S. Reinsurance Regulation - Direct and Indirect

Like insurance, reinsurance and U.S. based reinsurers are regulated by the states not the Federal government. U.S. states employ two methods of reinsurance regulation, both direct and indirect regulation.

Direct regulation is imposed on those reinsurers that opt to be licensed in the U.S. Reinsurers licensed in at least one U.S. jurisdiction are subject to the full spectrum of laws and regulations to which a primary insurer is subject including regulation for financial reporting and solvency. The exceptions to this general rule are rates and contracts. 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 for the most part, the forms that can be used to evidence the contractual terms.

Recognizing that an insurance marketplace as large as that found in the U.S. is in need of a substantial amount of reinsurance capacity, U.S. regulators permit U.S. and non-U.S. reinsurers to assume business on risks located in the U.S.

The states have developed a system of indirect regulation where 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 state criteria. If the criteria are met, the ceding insurer may record as an asset or a reduction in insurance liabilities for the effect of the reinsurance transaction. The fundamental concept underlying the U.S. regulatory view is that a reinsurer must either be licensed in a U.S. state and subject to a full spectrum of reinsurance regulation or, in lieu of regulation, provide security to ensure the payment of the reinsurer's obligations to ceding insurers. Credit for reinsurance is the cornerstone of reinsurance regulation.

Extraterritorial Application of Law

The RAA applauds Representatives Brown-Waite and Moore for addressing a key improvement in the efficiency of regulation of reinsurers: the elimination of the extraterritorial application of state laws. As a result of our 50-state system of regulation, significant differences have emerged among the states with respect to reinsurance regulatory requirements. 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 a system of accreditation for states to meet minimum standards for regulation. Unfortunately, this has not prevented states from pursuing varying and sometimes inconsistent regulatory approaches to reinsurance. One of the best examples of this phenomenon is the extraterritorial application of state laws.

Approximately 14 states apply their laws on an extraterritorial basis, meaning that the state law not only applies to insurers domiciled in that state but to insurers domiciled in other states if the extraterritorial state has granted a license to the insurer. For example, if a reinsurer domiciled in Ohio were entering into a contract with an insurance company domiciled in Massachusetts and either or both were licensed in other states, the reinsurer and insurer would abide by the Ohio and Massachusetts reinsurance requirements, but also to the reinsurance requirements of all other states that apply their laws on an extraterritorial basis. This is the case even if the contract between the reinsurer and ceding insurer does not have any risks associated with that particular state. Because reinsurance contracts are customarily written on a multi-state basis, it is inefficient and unnecessary to require the contracting parties to meet the legal regulatory and peculiarities of multiple jurisdictions for a single reinsurance transaction.

The RAA strongly supports the principle set forth in Title II, Section 201 that addresses these inefficiencies. This provision retains the ability of state insurance regulators to regulate their domestic insurers and reinsurers and the reinsurance transactions of their domestic insurance companies. The Act simply preempts the extraterritorial application of state law and articulates the types of laws that states cannot apply on an extraterritorial basis, including critical elements of the reinsurance

transaction, such as dispute resolution, governing law and requiring specific contract provisions. This provision will remove the burdensome and redundant requirements on the reinsurance transaction and will greatly improve efficiency.

Reinsurance Solvency Regulation

The RAA supports the principles set forth in Title II Section 202 that provides that the state of domicile of a reinsurer shall be solely responsible for regulating the financial solvency of the reinsurer if the state is an NAIC accredited state. The financial integrity and solvency of a reinsurer is a key factor in determining whether insurance companies should receive credit for reinsurance on their financial statements. Redundant and burdensome solvency regulation may affect where the reinsurance market deploys its capital and increases the transaction costs for insurers, and ultimately consumers. The Act eliminates duplicative solvency regulation of reinsurers by placing sole responsibility for solvency regulation on the reinsurers' home state regulator. The Act protects against a "race to the bottom" for solvency regulation by requiring that the home state must meet the accreditation standards set out by the NAIC. We would recommend that the statute also recognize states that substantially meet accreditation requirements.

Reinsurance is a global marketplace. Allowing the state of domicile of the reinsurance company to be the single regulator for solvency will help streamline reinsurance regulation significantly and will add much to the value of a U.S. license. The home state of the reinsurer will still be subject to the very stringent NAIC accreditation standards for solvency regulation. Because the NAIC requires that accreditation laws be

“substantially similar,” all accredited states have the same basic solvency protections and laws in place even if they may differ in some of the details.

The elements of reinsurance solvency regulation that all states require and will stay in place under the proposed legislation include: Conservative statutory accounting rules, minimum reserve standards, annual actuarial opinion requirements, detailed financial reporting on the annual statement and quarterly statement blanks, annual Certified Public Accounting audit reports, minimum capital requirements per the NAIC risk-based capital formula, state investment laws that provide minimum diversification and limits on investments, holding company laws for extraordinary dividends and intergroup transactions, and many other model laws that are required for accreditation. The NAIC accreditation system will still require the home state regulator to demonstrate how effectively the state enforces its solvency regulation standards. This includes how well the state performs desk audits, examinations, whether they take timely action when needed, that they have qualified staff and other review requirements.

Strong reinsurance solvency regulation is critical to the health of the insurance marketplace. This legislation keeps reinsurance solvency regulation intact. It does relieve the reinsurer from having to file supplemental and at times inconsistent financial information in as many as 50 states. Yet, it provides all states with access to financial information on a U.S. licensed reinsurer. This streamlined regulation will allow U.S. reinsurers to compete more effectively without compromising solvency regulation.

Credit For Reinsurance

The RAA supports the principle set forth in Section 202(b)(3) that the credit requirements of the domicile of the reinsurer should be exclusively applied to allow the ceding insurer to take financial statement credit in all other states. To achieve uniformity in the ceding companies financial statement requires a single state's credit statutes to apply. The NAIC's accreditation system and model credit for reinsurance law seeks to achieve this result. Inconsistent state implementation of the model has undermined that goal. This statutory provision will achieve the uniformity needed by ceding insurers and reinsurers.

Conclusion

The RAA supports this legislation and stands ready to work with Members of the House Financial Services Committee in moving it forward. As the Committee prepares to mark up this legislation, we welcome the opportunity to provide additional comments on the legislation to ensure the legislation adheres to its stated intent. The U.S. reinsurance industry competes on a global stage and its transactions are between sophisticated parties. We believe that reinsurance regulatory reform will improve the value of a U.S. reinsurance license and strengthen financial regulation.