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Department of the Treasury
Federal Insurance Office
1500 Pennsylvania Avenue, NW
Washington, DC 20220

Re: Public Input on the Report to Congress on the U.S. and Global Reinsurance Market (Docket # TREAS-DO-2012-0004)

Ladies and Gentlemen:

The Committee on Insurance Law of the New York City Bar Association is grateful for the opportunity to respond[1] to the FIO's June 27, 2012 Notice and Request for Comment.

The Committee comprises lawyers representing a diverse cross-section of the insurance community, including lawyers in private practice, in-house counsel at insurance carriers and producers across multiple lines of insurance business, trade association officials, regulators, policyholder lawyers, insurance arbitrators and other types of insurance professionals. This letter represents the views of the Committee as a whole and not necessarily those of any particular member thereof. Without limiting the foregoing, the views expressed herein do not purport to reflect the views of members of the Committee who are public officials, and such members have expressly abstained from all Committee deliberations concerning this letter, including the determination on whether to make a submission at all.

This letter sets forth our observations concerning (i) the overarching purposes of reinsurance, (ii) the role of reinsurance in the broader economy and (iii) recent and ongoing reforms in the regulation of reinsurance.

Summary Conclusion

Reinsurance is a critical component of the insurance business, allocating risks and capital more efficiently than would be the case in its absence. The professional standards, textual precedents and commercial practices

1 This letter was prepared by a subcommittee of the Committee on Insurance Law. The principal authors were William Latza, John Pruitt and Daniel Rabinowitz. Other subcommittee members included Rachel Coan, Matthew Gaul, Tandis Hassid, Jill Levy, David Luce, Patricia Lubey, Francine Semaya and Jared Wilner.

associated with reinsurance have developed over centuries (the earliest reinsurance arrangements and markets predate even the founding of the American colonies). Like any financial market or product, reinsurance is imperfect and imposes risks. However, we believe that those risks are sufficiently localized to the insurance sector itself that reinsurance cannot be said to cause systemic risk. Reinsurance largely promotes financial stability and economic activity as opposed to concentrating risks or distorting markets. In addressing reinsurance issues from a public policy standpoint, public officials should carefully distinguish between reinsurance and the sectors of the financial markets that contributed to the events of 2008. By the same token, the success of reinsurance does depend on thoughtful regulatory involvement. Although generally encouraged by recent developments in reinsurance regulation, we do urge continued efforts to reduce regulatory ambiguity and uncertainty and to regulate from the standpoint of widely shared public policy priorities.

Purposes and Effects of Reinsurance

Reinsurance is a form of insurance, both parties to which are themselves insurance companies. It is a contract of indemnity, pursuant to which one insurance company (most often called the "direct insurer" or "ceding company") is insured against the liabilities it has assumed under one or more insurance policies it has issued. The insurance company that provides this protection to the ceding company is most often called the "reinsurer" or the "assuming company". It is "the ceding by one insurance company to another of all or a portion of its risks for a stipulated portion of the premium."[2] Put another way, the ceding company reduces its maximum exposure in the event of a loss by purchasing the right to reimbursement from the assuming company for all or a portion (that is, the reinsured portion) of the loss.

The key characteristics of reinsurance are that it is a contract of indemnity and not one creating a primary obligation, that it does not generate fresh premiums and that the insurable interest of the entity reinsured is its insurance liability.[3] Reinsurance differs from direct insurance by conferring an immediate financial benefit on the indemnified entity. While a homeowner, for illustration, cannot recognize the loss until his home is destroyed, his insurer must establish current liabilities as a result of issuing a policy insuring his home against destruction. These liabilities include an "unearned premium reserve" representing the portion of the booked premium that corresponds to the unexpired portion of the policy term and loss reserves reflecting the amounts estimated to be necessary in order to pay losses under the policy. Subject to regulatory requirements, reinsurance permits the insurer to record a reduction in both those current liabilities.

The use of reinsurance reduces volatility of direct insurers' operating results, promotes the efficient use of capital and underwriting resources and allows for a greater number of insurers to participate in the market. Absent reinsurance, only the very largest insurers

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2 *Skandia America Reins. Corp. v. Schenck*, 441 F.Supp. 715, 724 (S.D.N.Y 1977).

3 As insurance companies themselves, reinsurers also cede reinsurance. That transaction is called a "retrocession" and the reinsurer that assumes the retrocession is called a "retrocessionaire". The retrocessionaire can retrocede, and so on, diversifying exposure to loss throughout the world-wide pool of insurance capital.

that have enough capital to withstand major loss events or to finance the strain on capital from writing new business could exist.

Risk management. First, and most importantly, reinsurance lays off risk, thereby transferring it to entities better able and more willing to bear it. This allows a direct insurer to calibrate its risk tolerance levels with more precision. For example, an insurer may wish to cap its losses from a particular event or exposure. In the property/casualty arena, the covered losses could be all losses from a single catastrophic event or from single peril (*e.g.*, windstorm or earthquake) or in a single geographic region. In the life insurance arena, reinsurance may serve to cap morbidity and mortality risk, persistency risk (the risk associated with policyholders' allowing policies to lapse or surrendering their coverage) or investment risk (credit, interest rate and reinvestment). In these examples, reinsurance allows these risks to be dispersed among multiple reinsurers, which may agree to be exposed to either "vertical" (losses above or below certain attachments points) or "horizontal" (*pro rata* exposure to a single tranche of losses) slices of the same risk.

The ability to cap or reduce risk exposure is critical to insurers, because otherwise they would have to hold more capital (for regulatory, rating and risk-management reasons) as a cushion against greater-than-expected losses or losses that are expected but with less frequency.[4] In addition, in the absence of reinsurance, insurers might face undiversified risks to specific geographic regions or perils. Reduced balance-sheet and earnings volatility resulting from reinsurance can moderate these effects and enable insurers to attract capital from investors to support their underwriting activity.

Increases underwriting capacity. Reinsurance increases ceding insurers' underwriting capacity by reducing net premiums and liabilities. Most states have laws that limit an insurer's net exposure to any single risk to 10 percent of its policyholder surplus. Regulators, rating agencies and market analysts closely watch individual insurers' premium volumes and total liabilities relative to their capital base to determine whether they are operating with too much leverage. Reinsurance, *ceteris paribus*, serves to reduce an insurer's net liabilities and net written premiums for purposes of calculating applicable ratios and net exposure. The principle underlying this accounting treatment is that the risk has been laid off to the reinsurer, as discussed above.

For example, an insurer that cedes 50% of its premiums and losses to a reinsurer will need to hold only half of the additional capital that it otherwise would need to hold for each additional policy (though the insurer may have a capital charge for ceded reinsurance), and the risk will be cut by half for purposes of applying the 10% single risk rule. In the life insurance arena, "ceding commissions" paid by reinsurers help compensate the ceding insurer for expenses borne by it in acquiring the risks in the first

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[4] Insurers are required to hold capital as a cushion in case losses under their policies exceed the assets they set aside as reserves. Insurance regulators and rating agencies monitor capital levels and form judgments concerning whether insurers are operating with a capital cushion that is adequate in relation to the volume of their insurance business or the size of their liabilities. They do this by calculating premium-to-surplus and liabilities-to-surplus ratios and risk-based capital and other similar ratios that they use to monitor insurers' activities. Commercial counterparties such as lenders and other investors will also be alert to insurers' capital adequacy.

place, such as the costs associated with compensating insurance agents or conducting underwriting activities. In each case, the reinsurance allows ceding companies to write larger risks and more insurance policies than they otherwise could write on a limited capital base, while spreading the costs associated with providing insurance more broadly across all of these risk-takers.

The result is that the insurer closest to the customer gets to maximize the use of its sales, underwriting, policy administration and claims resources, while reinsurers are able to absorb insurance risk exposures from ceding insurers and earn profits from insurance without having to build capabilities in these areas. In addition, the concentration of risk of specific perils or geographic locations is diminished, allowing insurers and reinsurers to bear risks across a more diversified, broader statistical sampling of exposures.

Allows sharing of risks and profits. Another use of reinsurance is to facilitate the involvement by multiple entities in marketing or underwriting primary insurance. Reinsurance allows different insurers who have partnered or entered into a joint venture on a product line to share in the underwriting results – one as the direct policy issuing company, the other as the reinsurer. Oftentimes, smaller insurers tap into risk models and underwriting expertise offered by their reinsurers. These would be very expensive for the direct insurers to procure on their own, and the reinsurance allows the ceding insurer and reinsurer to participate in the underwriting results. This allows the parties' interests to be aligned and, again, allows for more efficient deployment of capital and operating capabilities by allowing one party to focus on customer-facing activity while the other provides capital support and risk management expertise.

Transfers underwriting income and losses to different units within the same consolidated group. Many insurers are part of a group of companies under common ownership and control. Separate insurers exist within the group because they may operate in different jurisdictions, sell different products or use different distribution systems; they also may exist for purely historical reasons. Reinsurance allows the revenues and assets of a group of insurers under common ownership within a consolidated group to be pooled and redistributed within the group to maximize the use of the group's capital.

Transfers blocks of insurance business. Reinsurance is also used as a vehicle by which an insurer can sell to another a line of insurance or portfolio of existing policies. An insurer that wishes to exit a line of insurance may do so by finding a purchaser. The sale typically will be structured so that the seller cedes the premiums and liabilities in the specified line of insurance to the purchaser. The availability of reinsurance as a tool to transfer blocks of policies makes it possible for insurers to enter and exit lines of business more readily than they could otherwise; this, in turn, promotes the efficient deployment of capital and management resources.

Role of Reinsurance in the Broader Commercial Sphere and Financial Markets

Transparency and market discipline. Reinsurance is not a source or carrier of systemic risk.

For one thing, as insurance companies themselves, reinsurers are regulated by their domiciliary insurance regulators. For reinsurers domiciled in the United States, this means that their financial condition and operations are subject to detailed rules and careful scrutiny by actuaries, auditors and state examiners. Regulation includes financial solvency rules and oversight in such areas as reserves, investments and capital adequacy, along with corporate governance and transactions with affiliates. Uniform financial reporting and a comprehensive basis of accounting yield financial statements that are consistent and comparable period-to-period and company-to-company.

As another example, insurance laws in the U.S. have historically restricted the ability of cedents to record ceded reinsurance as a financial asset ("credit for reinsurance") where the reinsurer is based outside the U.S. and not licensed anywhere in the U.S. The premise of these laws has been that cedents should not be allowed to claim the financial benefits associated with reinsurance (*e.g.*, an increase to surplus or a reduction in liabilities) where the reinsurance has been ceded to carriers that are not subject to oversight by U.S. regulators. In such cases, as a precondition to claiming reinsurance as an asset, these laws and regulations impose obligations on the reinsurer to secure its obligations under the reinsurance contract by posting collateral in favor of the ceding company. As discussed *infra*, recent and ongoing reforms in these laws will have the effect of permitting credit even where the reinsurer is non-U.S. based, as long as such reinsurer is deemed sufficiently creditworthy and its home jurisdiction sufficiently rigorous in regulating insurance.

Collateral requirements are also a common *commercial* requirement imposed by the market itself. In other words, cedents may exercise leverage over reinsurers in the marketplace by insisting on security with respect to particular risks; reinsurers are thus forced to compete with one another on this basis. These restrictions, both regulatory and market-imposed, effectively mitigate both insurers' misuse of reinsurance to manipulate or obscure their own financial condition and their risk of exposure to the insolvency of any single reinsurer.

Inter-connectedness within and without the insurance sector. In its Final Rule and Interpretive Guidance concerning *Authority To Require Supervision and Regulation of Certain Nonbank Financial Companies*, issued in April 2012, the Financial Stability Oversight Council deemed "connectivity" to be an important determinant of systemic risk.[5] Last month, however, the International Association of Insurance Supervisors published its report *Reinsurance and Financial Stability*,[6] in which it concluded,

> Business relationships between cedents and reinsurers establish direct links which are frequently deepened by the extension of risk and capital management services offered by reinsurers. This intra-sector connectivity is unlikely to transcend the boundaries of the insurance market and spill over into the broader financial market as long as business relationships are

5 77 FR 21637 (Apr. 11, 2012) . https://www.federalregister.gov/articles/2012/04/11/2012-8627/authority-to-require-supervision-and-regulation-of-certain-nonbank-financial-companies#h-15

6 http://www.iaisweb.org/Other-papers-and-reports-46.

> confined to traditional reinsurance activities. . . . traditional reinsurance is unlikely to cause, or amplify, systemic risk . . . .[7]

We concur with this assessment. One reason that reinsurance differs in this regard from other forms of secondary transfers of financial risks (*e.g.*, derivatives, securitization, bank participations) is that it is more common for a major reinsurer to focus principally on reinsurance. By contrast, financial risks in other sectors are more likely to be transferred among similar kinds of firms, with less specialization among them as to primary or secondary versions of these exposures. As a result, direct writers of insurance are relatively less exposed to the insurance risks of peer carriers, and large reinsurers tend to be specialized in these risks as a matter of expertise. While certain non-insurance activities of reinsurers (such as writing derivatives or engaging in "synthetic" reinsurance through the use of securitization techniques) can expose those reinsurers and the broader market to financial risk, these activities historically have not been central to reinsurers' business. Reinsurers are, and should continue to be, subject to appropriate regulation in these areas as are other participants in those markets. However, these activities *per se* do not warrant additional regulation of reinsurers as such. Reinsurance has predominantly been insular to the insurance community rather than "inter-connected" with other sectors in the sense associated with the 2008 financial crisis.

Availability of substitutes to traditional reinsurance. Lack of substitutability is also believed to be an important factor contributing to systemic risk.[8] The reinsurance market is characterized by comparatively low barriers to entry. For example, each time an insured catastrophe has caused significant erosion of capital in the insurance sector during the past two decades (most notably, 1992's Hurricane Andrew, the terrorist attacks of September 11, 2001 and the Gulf of Mexico hurricanes of the mid-2000s), new reinsurers have been born in the marketplace to take advantage of attractive reinsurance pricing that typically is expected to follow major catastrophes. This demonstrates that capital flows relatively easily into the supply of reinsurance as demand warrants. Moreover, the same two decades have seen the development of capital market alternatives to traditional reinsurance, with the advent of insurance-linked securities such as catastrophe bonds, mortality bonds, closed block notes and others. There is no inherent lack of supply of, or substitutes for, reinsurance.

The policy challenge is to preserve, or even enhance, substitutability, while at the same time not exacerbating intra-sector risk or creating cross-sector risk. Scholars J. David Cummins and Mary A. Weiss identified credit risk exposure to reinsurance counterparties as an important risk of inter-connectedness within the insurance sector. While requiring full collateralization of reinsurance recoverables could mitigate that risk, it also could raise a barrier to the entry of fresh capital following a catastrophe.

In addition, certain reforms in the regulation of other financial products could pose unintended consequences for this substitutability if applied to reinsurance. For example, the Dodd–Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank")[9]

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7 *Id.* at 5.

8 J. David Cummins and Mary A. Weiss, *Systemic Risk and the U.S. Insurance Sector*, http://www.fic.wharton.upenn.edu/fic/papers/11/11-07.pdf .

9 P.L. 111-203.

imposed various new requirements on securitization markets, including conflict-of-interest rules. Were reinsurance to be regulated using the same approach, some of this ease of substitution for reinsurance might be vitiated. As an example, Section 621 of Dodd-Frank strengthens conflict-of-interest restrictions in asset-backed securities. An analogous approach in reinsurance might restrict the use of catastrophe bonds insofar as sponsoring insurers are inherently "interested" in such bonds *not* paying all their interest and principal (which would result in one or more payments to the insurer in respect of the specified insurable event). Such a result would frustrate the objective of allocating risks efficiently, including to the capital markets.

Principles of Regulation

As a general matter, regulation of reinsurance in the U.S. has historically been characterized by the following principal elements:

- Regulation of reinsurance, like that of insurance, has been a state, not Federal, activity.
- Although a type of insurance, a reinsurance contract *per se* is not sufficient to trigger a requirement that the issuer be licensed in the state where written. To illustrate, an insurer that writes an auto policy to a California driver must be licensed by the California insurance regulator. By contrast, if a second insurer indemnifies the risk on that same policy by means of reinsurance, such insurer need not be so licensed. (Its licensed or unlicensed status, however, may bear on whether the primary insurer can record the reinsurance as an asset, or under what circumstances.)
- A U.S.-based reinsurer, even if not licensed in the particular state where the ceding company is domiciled, can write reinsurance without posting collateral, with the ceding company still recording credit for the reinsurance coverage. By contrast, a non-U.S. reinsurer is typically required to post collateral.
- Reinsurance intermediaries (such as reinsurance brokers) must be licensed, but the emphasis on market conduct regulation is not as acute as with primary insurance because the consumers of reinsurance are themselves insurance companies, not "retail" purchasers of insurance.

In recent years, some of the dynamics described above have shifted.

- The Nonadmitted and Reinsurance Reform Act ("NRRA", enacted as Subtitle B of Title V of Dodd-Frank) limits credit-for-reinsurance jurisdiction to the domiciliary state,[10] but more generally contemplates a new uniformity and reciprocity in the way U.S. regulators treat non-U.S. reinsurers.
- In furtherance of this approach the NRRA empowers the FIO to invalidate state laws to the extent they treat non-U.S. insurers or reinsurers less favorably than an admitted insurer in that state, where the non-U.S. company is subject to a "covered agreement" (*i.e.*, an agreement between U.S. and the non-U.S. domicile providing for reciprocity in prudential regulation).[11]
- Similarly, new model credit-for-reinsurance requirements from the National Association of Insurance Commissioners ("NAIC") depart from the blanket rule

10 Dodd-Frank §531(a).

11 *Id.*, §502.

that non-U.S. reinsurers must post collateral. The new model requirements vest discretion in the state regulator to relax (or waive altogether) the collateral requirement depending on the financial strength, including the credit rating, of the reinsurer.[12]

- The new NAIC requirements have been adopted in some states, with more likely to follow, while some large states such as New York[13] and Florida[14] have independently adopted their own credit-for-reinsurance reforms.

These shifting regulatory dynamics are encouraging insofar as they streamline and simplify regulation by eliminating some of the extra-territoriality associated with a state-based system (that is, reducing the exposure of a single ceding company to multiple states' requirements), yet challenges remain. The "covered agreements" contemplated by Dodd-Frank will need to be implemented, and the Federal government's related preemption power will need to be exercised, in a way that does not disrupt the smooth functioning of the reinsurance markets by limiting the availability of reinsurance for any of the purposes we have outlined in this letter, by creating unnatural advantages or disadvantages for particular market segments or by overturning settled rules and practices in the state regulatory framework without clear and fully considered replacements. In addition, the provisions of Dodd-Frank that vest in the domiciliary state the exclusive power to regulate the solvency of "reinsurers" (defined in broad and subjective terms)[15] represent a departure from long-standing principles of state law and raise a number of potential ambiguities. As regulators and policymakers, including the FIO, examine these and related issues, we would encourage them to act with due regard for the characteristics of reinsurance that bring efficiency and capacity to the insurance marketplace with a minimum of risk to either consumers of insurance or the broader economy.

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Our Committee would be pleased to respond to any questions on the foregoing. The Committee also welcomes the opportunity to assist the FIO both in connection with Director McRaith's forthcoming report to Congress on reinsurance and, more generally, in advancing the FIO's important work.

Respectfully submitted,

Daniel A. Rabinowitz
Chair, Committee on Insurance Law

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12 NAIC Credit for Reinsurance Model Law, §2(E); NAIC Credit for Reinsurance Model Regulation, §8(A)(1).

13 NY Insurance Dept. Regs. 17, 20 and 20-A, eff. Jan. 1, 2011.

14 Fla. Admin. Code §69O-144.007.

15 Dodd-Frank §§532-33.