

**NEW YORK STATE INSURANCE DEPARTMENT
PROPOSES REGULATION TO ESTABLISH
MANDATORY CATASTROPHE RESERVE FUNDS**

Proposed Insurance Regulation 189 (the “Proposed Regulation”), which was recently published in the New York State Register, would require New York licensed property and casualty insurers to establish mandatory pre-event reserve funds for future losses to property located in New York arising out of natural catastrophes.¹

Insurers generally establish loss reserves to fund claims for known but unpaid losses. Current tax laws and accounting principles discourage U.S. property and casualty insurers from establishing reserves to pay for future catastrophe losses because the U.S. tax law does not permit the deduction of such reserves from current year revenues. Instead, payments for catastrophe losses are made from unrestricted policyholder surplus after the losses are incurred.

Although the New York State Insurance Department (the “NYSID”) generally supports changes to the U.S. tax laws to effectuate favorable treatment for catastrophe reserves, it deems the establishment of a source of funds to pay catastrophe claims a priority that should not be delayed pending federal action. In addition, the NYSID notes that property insurance premiums include a charge to policyholders for possible catastrophe losses, referred to in the Proposed Regulation as “catastrophe loads.” The Proposed Regulation would require New York licensed property and casualty insurers (domestic and foreign) to establish a mandatory catastrophe reserve to hold all such loads, net of the cost of reinsurance and of any federal, state and local income tax, to fund future catastrophe losses.

The NYSID recognizes that whereas current property insurance premiums generally include amounts for catastrophe coverage, catastrophic events tend to arise as a very small number of very costly events spread out over many years. Such inclusion of catastrophe charges results in higher underwriting gains for insurers in years in which no catastrophes occur. The Proposed Regulation thus requires insurers to retain such gains as a reserve for future catastrophe losses. The mandatory catastrophe reserve that would be established under the Proposed Regulation is intended to (a) create a stabilizing effect on policyholders’ premiums over time and (b) facilitate the insurers’ ability to fund catastrophic losses (while mitigating the large fluctuations in the insurers’ policyholder surplus that can result from such catastrophic losses).

¹ The Proposed Regulation and related documents are available on the New York Insurance Department’s website at <http://www.ins.state.ny.us/rproindx.htm>.

Specific Provisions of the Proposed Regulation

Authorized New York insurers would be required to establish a mandatory catastrophe reserve in an amount equal to the aggregate catastrophe load included in premiums collected on personal and commercial direct insurance policies and reinsurance contracts insuring property located in the State of New York. The following types of insurance, written on a direct or assumed reinsurance basis, are subject to the requirements under the Proposed Regulation: fire, miscellaneous property, water damage, collision, and marine and inland marine insurance. However, insurers are not required to fund the mandatory catastrophe reserve with respect to assumed reinsurance premiums on excess of loss reinsurance contracts.

A catastrophe is defined as a natural event that is designated as a catastrophe by the Property Claims Service division of the Insurance Services Office and that either (i) causes \$250 million or more in industry-wide direct insured losses in the United States (and results in “qualifying losses”²) or (ii) causes \$25 million in direct insured losses, results in qualifying losses and results in a 10% reduction in the insurer’s policyholder surplus in any calendar year.

In the event of a natural catastrophe causing loss to insured New York property, insurers may convert the mandatory catastrophe reserve, or a portion thereof, to an event-specific loss reserve. Notice of such conversion must be provided to the NYSID within 30 days. Amounts not ultimately expended to pay qualifying losses must be returned to the mandatory catastrophe reserve.

Under the Proposed Regulation, the mandatory catastrophe reserve would have a 30-year rolling term, so that at the end of the 30th year, the first year’s annual contribution (including investment income), to the extent not used to fund qualifying losses, would be taken into income. The same pattern of practice would continue each year thereafter. A property and casualty insurer subject to the Proposed Regulation would be required to report its mandatory catastrophe reserve in its financial statements submitted to the NYSID.

Insurance Industry Reaction

The Proposed Regulation was originally introduced by the NYSID on October 4, 2007 and has garnered mixed reactions from the insurance industry. While certain property and casualty insurers claim to have been advocating for this type of regulation, a number of property and casualty insurance industry groups have expressed their concerns to the NYSID regarding the lack of favorable tax treatment for catastrophe loss reserves. In response to these comments, the NYSID indicated that the Proposed Regulation was amended to provide that the reserves be established net of any federal and state taxes incurred.

² “Qualifying losses” are defined as losses and loss adjustment expenses incurred, net of reinsurance, resulting from loss to property located in New York which are directly attributable to a catastrophe in New York State.

Comments also reflect concerns that the single-state nature of the Proposed Regulation will make it difficult to properly identify the amount of premium and catastrophe load attributable to the catastrophe reserve and make it difficult for affected reinsurers to obtain required information from cedents. The NYSID also received several comments from interested parties asserting that the catastrophe reserve requirement should be implemented on a nationwide basis rather than by a single state. In response, the NYSID is pursuing national application of the catastrophe reserve proposal via the National Association of Insurance Commissioners (the “NAIC”) and specifically included in the most recent version of the Proposed Regulation provisions recognizing reciprocity with any other state that requires catastrophe reserving.

NAIC’s Proposal for Pre-Event Catastrophe Reserve Funds

Since the mid 1990’s, the NAIC has considered the development and establishment of pre-event catastrophe reserve funds. The NAIC’s Voluntary Tax-Deferred Pre-Event Catastrophe Reserve Proposal (the “NAIC Proposal”), originally introduced in July of 1997 and most recently amended in 2001, proposed voluntary pre-event catastrophe reserves that were calculated using a formula based on the amount of business an insurer writes in the lines of insurance potentially affected by a catastrophic event. The NAIC Proposal contemplated that such reserves would result in tax deferral under federal tax law and that implementation of the reserves would not be effectuated unless and until such tax deferral is granted.

The NAIC Proposal has prompted varied reactions from the insurance industry and other interested parties since its introduction. Industry participants were in general agreement that pre-event catastrophe reserving would be useful only with the availability of tax deferral. Some industry participants claimed that the establishment of a catastrophe reserve would convert a portion of an insurer’s potential profit into a liability, thereby reducing the insurer’s surplus and ability to write additional business.

To date, Congress has not changed federal tax law to permit insurers to establish reserves for future catastrophic events on a tax-deductible basis,³ and the NAIC has not adopted the NAIC Proposal. Since its initial introduction, the NAIC has been asked from time to time to reconsider adopting the NAIC Proposal. The NAIC Proposal is still pending, and the NAIC currently maintains its position that the ability of insurers to establish pre-event catastrophe reserves will require an amendment to federal tax law to permit tax deferral with respect to such reserves.

³ On February 11, 2009, H.R. 998, a bill titled the “Policyholder Disaster Protection Act of 2009,” was introduced in the House of Representatives and referred to the Committee on Ways and Means. H.R. 998 would amend the Internal Revenue Code to permit property and casualty insurers to contribute pre-tax dollars into a policyholder disaster protection fund, which would pay claims arising out of certain qualified natural catastrophes. Similar bills introduced in the past have not been enacted, and commentators believe that H.R. 998 also is unlikely to receive Congressional approval.

While New York has actively participated in the discussions with the NAIC regarding the development and implementation of pre-event catastrophe reserve funds on a nationwide basis, it does not appear that the NAIC would likely change its current position to wait for the amendment of the Internal Revenue Code to permit tax deferral with respect to such reserve funds. The NYSID's decision to move forward with the promulgation of the Proposed Regulation despite the NAIC's reluctance is consistent with New York's history of being the forerunner with respect to various insurance regulatory schemes.

The Proposed Regulation is currently subject to a 45-day public comment period. According to the NYSID, there was no public hearing held for the Proposed Regulation, and no such hearing is expected to be held.⁴ The NYSID expects robust comments from the insurance industry during the 45-day period. Upon conclusion of the comment period on or around May 23, 2009 and based on the review of the comments received, the NYSID will decide whether to revise or promulgate the Proposed Regulation.

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If you have any questions regarding this memorandum, please contact Leah Campbell (212-728-8217, lcampbell@willkie.com) or the Willkie Farr & Gallagher attorney with whom you regularly work.

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⁴ See Notice of Rule Making available on the NYSID's website at <http://www.ins.state.ny.us/rproindx.htm>.