WILLKIE FARR & GALLAGHER LLP

CLIENT ALERT

NAIC Approves Revisions to Credit for Reinsurance Model Law and Regulation

July 2, 2019

AUTHORS

Leah Campbell | Deidre B. Derrig | Allison J. Tam

On June 25, 2019, the National Association of Insurance Commissioners (the "NAIC") adopted revisions (the "2019 Amendments") to the NAIC Credit for Reinsurance Model Law (#785) and Regulation (#786) (together, the "Credit for Reinsurance Models") to conform to the requirements of the bilateral agreements ("covered agreements") on insurance and reinsurance between the United States (the "U.S.") and the European Union (the "EU") and between the U.S. and the United Kingdom (the "UK"), respectively (together, the "Covered Agreements"). But the 2019 Amendments address more than EU- and UK-domiciled reinsurers – the revisions also affect reinsurers from other nations as well as U.S. reinsurers. The newly amended Credit for Reinsurance Models are layered and complex; layered because the changes to the Models add to reinsurance credit regulation from past decades, and complex because the reinsurer, and in many cases its domestic jurisdiction, are subject to evaluation and approval by U.S. regulators.

The 2019 Amendments pave the way for state legislatures to bring their credit for reinsurance laws into compliance with the Covered Agreements' zero reinsurance collateral provisions by September 2022, thereby avoiding potential federal preemption of these laws. At the upcoming NAIC 2019 Summer National Meeting, the Financial Regulation Standards and Accreditation (F) Committee will consider whether all or part of the 2019 Amendments will be a uniform accreditation standard applicable to all NAIC-accredited jurisdictions.

THE JOURNEY FROM FULL COLLATERAL TO REDUCED COLLATERAL TO ZERO COLLATERAL

A U.S. cedent's reinsurance recoverables are recognized on its statutory financial statements as an asset or a reduction of liabilities if certain requirements are met. In the past, the cedent's requirement to obtain reinsurance collateral was mainly driven by whether or not the reinsurer was a U.S.-licensed insurer/reinsurer. Whereas a licensed reinsurer could be exempt from statutory collateral requirements, the recoverables of an unlicensed reinsurer were subject to full collateralization.[1] In general, as long as the "unlicensed" reinsurer posted the full collateral (and the reinsurance agreement satisfied certain requirements) the cedent could claim statutory credit.

The 2019 Amendments change the credit for reinsurance and collateral dynamics in several ways, as summarized below.

The zero reinsurance collateral process reflected in the 2019 Amendments is founded on the requirements of the Dodd-Frank Act and its offspring, the Covered Agreements. In sum, each of the Covered Agreements require *inter alia* that no reinsurance collateral obligations be applied to qualifying reinsurers domiciled in the EU or the UK, as applicable. In November 2015, pursuant to the authority granted by the Dodd-Frank Act, the U.S. Department of the Treasury ("Treasury") and the U.S. Trade Representative (the "USTR"), on behalf of the U.S., and the EU, began negotiating the legal text of the U.S./EU Covered Agreement. After its submission to Congress, this bilateral agreement was signed on September 22, 2017. In December 2018, and in anticipation of Brexit, the U.S. and the UK entered into the U.S./UK Covered Agreement with terms consistent with those of the U.S./EU Covered Agreement.

Independent of the covered agreement process, in 2011 the NAIC adopted changes to the Credit for Reinsurance Models that permitted "reduced collateral" for reinsurers domiciled in certain "qualified jurisdictions" (the "2011 Amendments"). Therefore, the amended Credit for Reinsurance Models incorporate two distinct approaches to reduced and/or zero reinsurance collateral as set forth in the 2011 Amendments and the 2019 Amendments.

2011 Amendments and Reduced Collateral

The 2011 Amendments reduced, in some cases to zero, the reinsurance collateral requirements applicable to a newly created category of "certified" non-U.S. reinsurers ("Certified Reinsurers") domiciled in approved non-U.S. jurisdictions listed by the NAIC and approved by the states (a "Qualified Jurisdiction"). Using a standardized process similar to the state-based accreditation process, the NAIC determines whether another nation's reinsurance supervisory system achieves an acceptable level of effectiveness in financial solvency regulation (referred to as the *NAIC Process for Developing and Maintaining the NAIC List of Qualified Jurisdiction*s or the "NAIC Qualified Jurisdiction Process"). The

1 The 2019 Amendments and this memorandum refer only to single-cedent credit for reinsurance requirements. Multi-beneficiary trusts and similar credit for reinsurance constructs, as well as authorized and approved reinsurers, are not discussed in this memorandum.

NAIC List of Qualified Jurisdictions is not binding on states, and each state may also evaluate a non-U.S. jurisdiction to determine if it should be deemed a Qualified Jurisdiction by that state only.

By May of 2019, all but one state had adopted the 2011 Amendments in varying forms; Bermuda, France, Germany, Ireland, Japan, Switzerland and the UK had achieved Qualified Jurisdiction status through the NAIC Qualified Jurisdiction Process; and the Certified Reinsurer provisions of the 2011 Amendments became a required and uniform accreditation standard applicable to all NAIC-accredited jurisdictions on January 1, 2019. The 2011 Amendments must now make room for the changes brought by the Covered Agreements and the 2019 Amendments. The 2011 Amendments have not been nullified by the 2019 Amendments; however, the usage of the Certified Reinsurer path in the future will likely be reduced.

Advent of the Covered Agreements

Under the Dodd-Frank Act, the Covered Agreements may preempt an inconsistent state law that treats a qualified non-U.S. reinsurer less favorably than a U.S. insurer licensed in the state. If, by September 2022, state credit for reinsurance laws based on the Credit for Reinsurance Models fail to afford reinsurers the zero reinsurance collateral treatment provided for in each of the Covered Agreements, they will be subject to federal preemption. In light of this potential preemption, the NAIC adopted the 2019 Amendments to the Credit for Reinsurance Models, just eight years after the 2011 Amendments, in order to bring them into compliance with the Covered Agreements. The 2019 Amendments were adopted expeditiously, with only 16 months elapsing from the initial February 20, 2018, public hearing on the 2019 Amendments to their June 25, 2019, adoption.

2019 (Covered Agreements) Amendments to the Credit for Reinsurance Models

During the NAIC hearings and drafting process, the breadth of the 2019 Amendments was expanded to afford zero reinsurance collateral treatment not to only EU and UK Covered Agreement qualifying reinsurers but also to qualifying non-U.S. reinsurers domiciled in certain nations and U.S. reinsurers domiciled in NAIC-accredited jurisdictions. In order to qualify for zero reinsurance collateral treatment, the 2019 Amendments require eligible reinsurers to be domiciled in one of three kinds of "<u>Reciprocal Jurisdictions</u>" ("<u>RJs</u>"):

i) non-U.S. jurisdictions that enter into a covered agreement with the U.S. (e.g., currently, the EU and, after Brexit, the UK) ("<u>Covered Agreement RJs</u>," and their domestic reinsurers are referred to as "<u>Covered Agreement RJ Reinsurers</u>");

ii) non-U.S. jurisdictions that (a) are Qualified Jurisdictions as determined by the NAIC Qualified Jurisdiction Process (described above) <u>and</u> (b) comply with certain additional requirements, consistent with the terms and conditions of in-force covered agreements, including the elimination of a requirement that a U.S.-domiciled reinsurer maintain a local presence in the Qualified Jurisdiction in order to assume reinsurance from a ceding insurer domiciled in the non-U.S. jurisdiction and recognizing the U.S. statutory regulatory approach to group supervisor ("Qualified Jurisdiction RJs," and their domestic reinsurers are referred to as "Qualified Jurisdiction RJ Reinsurers"); and

iii) all U.S. jurisdictions that are accredited by the NAIC ("NAIC RJs," and their domestic reinsurers are referred to as "NAIC RJ Reinsurers").

The NAIC will maintain a list of Reciprocal Jurisdictions for this purpose, utilizing a yet-to-be developed process ("NAIC Reciprocal Jurisdiction Process") which is expected to be similar to the current NAIC Qualified Jurisdiction Process.

In early drafts of the 2019 Amendments, the Dodd-Frank/Covered Agreement-driven zero reinsurance collateral provisions applied only to Covered Agreement RJ Reinsurers. Industry commenters successfully advocated to expand the definition of Reciprocal Jurisdictions to include Qualified Jurisdictions and NAIC-accredited jurisdictions, reasoning that the reinsurance supervisory systems and financial solvency regulations of these jurisdictions had already been vetted and approved by the NAIC. Ironically, NAIC-accredited jurisdictions were a last-minute addition without which U.S.-domiciled reinsurers would have been in a position of potentially collateralizing assumed risks from U.S.-ceding insurers (while their reinsurer counterparts from Covered Agreement RJs and Qualified Jurisdiction RJs would be exempt from doing so). In addition to remedying this discrepancy, later drafts also "leveled the playing field" for Qualified Jurisdiction RJs and Covered Agreement RJs by prohibiting state insurance commissioners from imposing additional criteria on a Qualified Jurisdiction RJ and on a Qualified Jurisdiction RJ Reinsurer unless such criteria is consistent with that of an in-force covered agreement.

Under the 2019 Amendments, a reinsurer does not automatically qualify for zero reinsurance collateral by virtue of its domicile in a Reciprocal Jurisdiction; rather, the reinsurer must satisfy financial, rating and commercial standards (e.g., minimum capital and surplus, minimum solvency or capital ratios, submission to U.S. jurisdiction, absence of participation in a solvent scheme of arrangement, submission of certain documentation to the U.S. regulatory bodies, prompt payment of claims, etc.). The 2019 Amendments employ a two-step process which evaluates not only the Reciprocal Jurisdiction, but also the financial strength of the reinsurer from that Reciprocal Jurisdiction similar to the process under the 2011 Amendments applicable to Certified Reinsurers from Qualified Jurisdictions.

POTENTIAL IMPACT OF THE 2019 AMENDMENTS

The 2011 Amendments and the 2019 Amendments are cumulative, resulting in five distinct categories of reinsurers under the Credit for Reinsurance Models: Fully Collateralized Reinsurers, Certified Reinsurers, Covered Agreement RJ Reinsurers, Qualified Jurisdiction RJ Reinsurers and NAIC RJ Reinsurers. Only reinsurance agreements entered into, amended or renewed on or after the effective date of a state statute encompassing the 2019 Amendments are eligible for reinsurance collateral elimination and only with respect to losses incurred and reserves reported on or after the later of (i) the date on which the assuming reinsurer has met all eligibility requirements under such statute and (ii) the effective date of the new reinsurance agreement, amendment or renewal. Therefore, it will likely be necessary for some U.S.-ceding insurers to rely on one or more of the five categories of reinsurers when claiming statutory reinsurance credit, especially those insurers ceding legacy and run-off business.

It is expected that reinsurers domiciled in nations that do not have a covered agreement with the U.S. will seek designation as a Qualified Jurisdiction RJ Reinsurer, thereby benefitting from zero reinsurance collateral treatment subject to specific minimum criteria that does not include a minimum financial strength rating. This assumes that such reinsurer's domestic jurisdiction qualifies as a Reciprocal Jurisdiction under the 2019 Amendments. Absent having a home jurisdiction with a Reciprocal Jurisdiction status, reinsurers from other nations would revert to the Certified Reinsurer path (if their domestic jurisdiction qualified) or potentially be subject to full collateral requirements. Using a Certified Reinsurer/Qualified Jurisdiction path would make the reinsurer subject to financial strength rating criteria, reduced rather than zero collateral and the U.S. regulator's discretion as to certain standards.

The question then is whether the 2019 Amendments will override and render moot the Certified Reinsurer process. This will depend on whether foreign jurisdictions seek to initiate bilateral negotiations with the U.S. so that its reinsurers benefit from zero reinsurance collateral treatment or, alternatively, seek designation as a Qualified Jurisdiction RJ thereby allowing its domiciled eligible reinsurers equivalent treatment.

The NAIC continues to maintain a prominent role in operationalizing the terms of the Credit for Reinsurance Models, whether it be in administrating the NAIC Qualified Jurisdiction Process or the NAIC Reciprocal Jurisdiction Process. Although state insurance commissioners are charged with publishing a list of Reciprocal Jurisdictions, in marked contrast to the discretion afforded state commissioners under the 2011 Amendments, the list must include Covered Agreement RJs and NAIC RJs with state insurance commissioners having no ability to remove these Reciprocal Jurisdictions from the list. According to a drafting note to the 2019 Amendments, the NAIC will coordinate with Treasury, the USTR and other relevant federal authorities to include a process for the revocation or suspension of the status of a Reciprocal Jurisdiction.

If you have any questions regarding this client alert, please contact the following attorneys or the Willkie attorney with whom you regularly work.

Leah Campbell
212 728 8217
lcampbell@willkie.com

Deidre B. Derrig
202 303 1274
dderrig@willkie.com

Allison J. Tam
212 728 8282
atam@willkie.com