



Two Federal Bills Regulating Insurance and Reinsurance Are Proposed

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Two bills purporting to regulate insurance and reinsurance are currently pending in Congress. One, the Nonadmitted and Reinsurance Reform Act of 2009, would streamline the regulation of nonadmitted insurance and reinsurance companies. This bill has been passed in the House of Representatives, and is pending in the Senate. The other, the Reinsurance Regulatory Modernization Act of 2009, was drafted by the National Association of Insurance Commissioners (“NAIC”) and deals exclusively and in more detail with reinsurance, streamlining regulation and creating standardized rating and collateral requirements. Either bill could have a significant effect on the insurance and reinsurance industries, which generally have not been subject to federal regulation.

NONADMITTED AND REINSURANCE REFORM ACT OF 2009

On September 9, 2009, the U.S. House of Representatives passed the “Nonadmitted and Reinsurance Reform Act of 2009” (the “Act”). Currently in the Senate Committee on Banking, Housing, and Urban Affairs, the Act would streamline the regulation of nonadmitted insurance and reinsurance. A nonadmitted insurance transaction is the placement of insurance with an insurer not licensed to do business in the state where the insured resides. The Act would designate one state, the domiciliary state of the insured (the “Home State”), to tax each nonadmitted insurance transaction, and would encourage states to establish procedures to allocate premium taxes among themselves. Nonadmitted insurance transactions would be subject to the regulatory requirements of only the Home State of the insured, meaning one set of requirements for each transaction. Furthermore, only an insured’s Home State could require a Surplus Lines Broker to be licensed to conduct nonadmitted insurance with respect to that insured, and a state would be prohibited from collecting broker licensing fees from Surplus Lines Brokers unless it participates in the NAIC’s national insurance producer database, or a similar uniform national database. Finally, the Act would require states to adopt uniform standards for surplus lines eligibility.

Regarding reinsurance regulation, the Act would require that all states give credit to ceding insurers for reinsurance when the ceding insurer’s state of domicile gives such credit, so long as the domicile state is NAIC-accredited or has equivalent financial solvency standards. Also, the domiciliary state of the reinsurer would be solely responsible for regulating solvency, so long as that state was NAIC-accredited or had similar solvency requirements.

Taxing Premiums for Nonadmitted Insurance

While the Act would allow only the Home State to tax premiums on nonadmitted insurance, it would allow, and in fact encourages, states to enter into a compact or otherwise establish

procedures to allocate those premium taxes among themselves. It is Congress' intent that through such a compact, each state will adopt nationwide uniform requirements, forms, and procedures for the reporting, payment, collection, and allocation of these premium taxes. To facilitate the taxes, the Home State may require surplus lines brokers (or insureds, where they have independently procured insurance) to file a tax allocation report on an annual basis.

Regulation of Nonadmitted Insurance

Under the Act, the placement of nonadmitted insurance may be regulated only by the insured's Home State. The Home State would also be the only state permitted to require that a surplus lines broker be licensed in order to sell, solicit, or negotiate nonadmitted insurance with respect to that insured. A state may collect surplus lines broker licensing fees only if the state participates in the NAIC's national insurance producer database, or some equivalent.

For domestic (U.S.) insurers, the state's regulation of surplus lines eligibility must conform to the requirements and criteria in sections 5A(2) and 5C(2)(a) of the NAIC's Nonadmitted Insurance Model Act, or some equivalent criteria created in a compact among the states as described above. The Nonadmitted Insurance Model Act requires that the nonadmitted insurer be authorized to write that type of insurance in its domiciliary jurisdiction, and also includes minimum capital and surplus requirements.

For nonadmitted insurers domiciled outside the U.S., a state may not prohibit a surplus lines broker from placing insurance with that insurer, so long as that insurer is listed on the NAIC's Quarterly Listing of Alien Insurers.

Finally, there is a provision streamlining the application procedure for "exempt commercial purchasers." For those insureds meeting the criteria, essentially aimed at large companies, this provision would allow brokers to place nonadmitted insurance without meeting 'diligent search' requirements, which normally require a surplus lines broker to first make a diligent search for the desired insurance within the admitted market.

Reinsurance Regulation

The Act would regulate "credit" for reinsurance. Where a ceding insurer is domiciled in a state that is NAIC-accredited or has substantially similar financial solvency requirements, and the state of domicile recognizes credit for reinsurance for the ceded risk, then no other state may deny such credit; the Act would preempt state laws preventing the ceding insurer from taking reinsurance credit under those circumstances. Thus, under the Act, only the domicile state – where that state is NAIC-accredited or has substantially similar financial solvency requirements – may regulate credit for reinsurance.

The solvency of reinsurers themselves would be regulated only by the reinsurer's state of domicile. Again, this is true so long as that state is NAIC-accredited or has substantially similar financial solvency requirements. If this is the case, then no other state may require the reinsurer to provide any additional financial information, other than the information the reinsurer is required to file with its domiciliary state.

Possible Implications

If enacted, the Act would simplify the taxation of nonadmitted insurance premiums, which can currently be complex and difficult. Each individual non-admitted insurance transaction would be governed by a single set of regulatory requirements, further simplifying these transactions. The Act would also spur the creation of uniform standards for surplus lines eligibility, most likely through more widespread adoption of the NAIC's Nonadmitted Insurance Model Act.

Similarly, under the Act reinsurance transactions would be regulated only by one state, simplifying regulatory compliance for those transactions. Also, the financial solvency of a reinsurance company would be regulated by only one state, so long as that state was NAIC-accredited. This makes it likely that financial solvency requirements will become more uniform.

REINSURANCE REGULATORY MODERNIZATION ACT OF 2009

On September 15, 2009, the NAIC voted to submit to Congress a bill that would provide for federal regulation of the reinsurance industry. Described by the NAIC as an "extension" of the Nonadmitted and Reinsurance Reform Act, the "Reinsurance Regulatory Modernization Act of 2009" (the "NAIC Act") would create a federal agency called the Reinsurance Supervision Review Board (the "Board") for the purpose of evaluating and certifying state regulators and to promulgate standards by which those regulators will evaluate reinsurers. Standards would include capital and surplus requirements and mandatory contractual terms; these standards would be uniform across all certified states. Reinsurers would be evaluated by the state agency and assigned a rating, which would impose corresponding collateral requirements. Each reinsurer would be subject only to the regulatory authority of its "Home State," or "Port of Entry State" for foreign reinsurers. If enacted, the NAIC Act would be the first federal legislation to regulate reinsurers specifically, and would thus have a significant impact on the reinsurance market.

The Board and State Regulators

The Board would be composed of fifteen directors appointed by the President with the advice and consent of the Senate, and would include ten directors from state insurance regulatory authorities to be nominated by the NAIC, and five directors from the Department of the Treasury, Department of Commerce, and the Office of the United States Trade Representative. Directors would each serve 3 year staggered terms (although ten of the initial appointees would serve only 1 or 2 year terms).

The Board is primarily responsible for certifying state regulatory authorities, and for promulgating standards and requirements that those authorities must use in evaluating reinsurers. The Board will certify a state insurance regulatory authority as a Home State Supervisor or Port of Entry State Supervisor. A Home State Supervisor can certify a reinsurer licensed and domiciled in that state, allowing it to transact reinsurance business across the United States. Such a "National Reinsurer" is subject to regulation only by its Home State Supervisor. A Port of Entry State Supervisor can similarly certify a non-U.S. reinsurer that is organized in and licensed by a foreign jurisdiction, so long as that jurisdiction has been approved by the Board. As with National Reinsurers, a certified "Port of Entry Reinsurer" will

be subject to the regulatory authority of only one jurisdiction – the Port of Entry State Supervisor.

In order to be certified as a Home State or Port of Entry State Supervisor, a state insurance authority must adopt model laws for reinsurance activities established by the NAIC. Furthermore, they must comply with uniform standards, adopted by the Board, for reinsurance supervisory systems to regulate the business transacted by reinsurers certified as either National Reinsurers or Port of Entry Reinsurers within their jurisdiction.

Requirements and Ratings Standards for Reinsurers

In order to be certified as a National Reinsurer or Port of Entry Reinsurer by a Home State or Port of Entry State Supervisor, a reinsurance company will be required to meet a minimum capital and surplus requirement of \$250 million. This requirement may be adjusted by the Board. Furthermore, each reinsurer will be evaluated by the Supervisor and assigned a rating between one and five, with one being the most secure and five being the least. These ratings have corresponding collateral requirements, meaning that for a domestic ceding insurer to get “credit” for reinsurance ceded to a certified reinsurer, that reinsurer must post collateral in the United States, calculated as a percentage of the reinsurer’s liabilities for all reinsurance ceded by U.S. ceding insurers based upon the reinsurer’s rating. If the reinsurer does not post such collateral, a ceding insurer will not get credit for the reinsurance.

Collateral percentages will differ for National Reinsurers and Port of Entry Reinsurers. For National Reinsurers with a rating of “Secure – 3” or better, no collateral will be required. For those with a rating of “Secure – 4,” collateral in the amount of 75% of liabilities will be required. A “Vulnerable – 5” rating – the lowest rating – will require a reinsurer to post collateral for 100% of liabilities. Port of Entry Reinsurers will be required to post collateral as follows:

<u>Ratings</u>	<u>Collateral Required</u>
Secure – 1	0%
Secure – 2	10%
Secure – 3	20%
Secure – 4	75%
Vulnerable – 5	100%

If a reinsurer meets the \$250 million surplus requirement and the collateral requirement appropriate for its rating, a state insurance authority must give credit to domestic insurers for reinsurance purchased from that company.

The ratings above will be determined by the Home State or Port of Entry State Supervisor through an evaluation governed by standards adopted by the Board. The standards will lay out considerations that the Supervisor must take into account, and must include, but are not limited to:

- Financial Strength Rating as determined by two (2) rating agencies;
- Compliance with reinsurance contractual terms and obligations, including contractual clauses deemed mandatory by the Board;
- Business practices of the reinsurer in dealing with ceding insurers;

- A review of the most recent applicable NAIC Annual Statement Blank (for National Reinsurers) or an equivalent (for Port of Entry Reinsurers);
- The reinsurer's reputation for prompt payment of claims, including proportion of past due or disputed claims;
- Regulatory actions against the reinsurer;
- An independent auditor's report of financial statements;
- For Port of Entry Reinsurers, audited financial statements, regulatory filings, and actuarial opinions;
- A reinsurer's participation in any solvency scheme of arrangement which involves U.S. ceding insurers; and
- Any other information deemed relevant by the Supervisor.

There are also special procedures and requirements in the event of catastrophic occurrences; rehabilitation, liquidation, or conservation orders against ceding insurers; affiliated reinsurance transactions; and changes in reinsurer ratings. The NAIC Act confers no private right of action for any reinsurer against a Home State or Port of Entry State Supervisor arising out of a ratings determination; such reinsurer may pursue only that review which is permissible under the laws and regulations of its Home State or Port of Entry State.

Preemption, Opt-Out

The NAIC Act, if enacted, would preempt all laws, regulations, provisions and other actions of a state that would otherwise be inconsistent with the NAIC Act. More specifically, when a certified National or Port of Entry Reinsurer transacts business with a ceding insurer in any state, that state must give the ceding insurer credit for the reinsurance, regardless of the state's own laws and regulations. Furthermore, no state may impose collateral requirements on certified reinsurers different than those promulgated by the Board, and no state but the Home State or Port of Entry State may regulate the reinsurer's financial condition. Finally, if a state refuses or limits credit for reinsurance in a way that is inconsistent with the NAIC Act, the aggrieved ceding insurer may seek Board review of that state's action. Only if the Board denies relief may the insurer file an action in federal court.

However, under the NAIC Act states may still impose their own regulations regarding credit for reinsurance where the reinsurer is not a certified National or Port of Entry Reinsurer at the time the reinsurance is ceded. Therefore, a reinsurer could choose not to become certified, and thus would continue to operate under the current state regulatory scheme.

Possible Implications

If enacted, this NAIC Act would create the first federal reinsurance regulatory system, streamlining and standardizing reinsurance regulations across the country under the auspices of a federal agency. This new regulatory regime would prevent a certified reinsurer from having to meet different capital, collateral and other financial standards in different jurisdictions in which it transacts reinsurance business, and would provide enhanced and

uniform financial regulation for the security of ceding insurers. Furthermore, it would allow reinsurers to deal exclusively with a single state regulator, its Home State or Port of Entry State Supervisor. One aspect of the NAIC Act that will likely prompt closer examination is the power given to the NAIC. Under the NAIC Act, the NAIC is responsible for recommending standards for state supervisor qualifications, nominating ten of the Board's fifteen directors, establishing model laws for reinsurance activities (which states would have to adopt to become certified), and recommending standards for reinsurance company ratings. In many ways, the NAIC would de facto have significant influence over the Board.

CONCLUSION

The legislative prospects for both bills are unclear. However, given the current economic and political environment, it is possible that Congress may view some type of federal regulation of the insurance and reinsurance industries as essential. We will continue to monitor the progress of both bills and that of other regulatory developments that would have an effect on insurers and reinsurers.

If you have any questions concerning this paper, please contact Andrew Amer (212-455-2953; aamer@stblaw.com).

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