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TESTIMONY

OF

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PERSPECTIVES ON MODERNIZING
INSURANCE REGULATION

BEFORE

UNITED STATES SENATE
COMMITTEE
ON
BANKING, HOUSING AND URBAN AFFAIRS

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My name is Frank Nutter and I am President of the Reinsurance Association of America (RAA). The RAA is a national trade association representing property and casualty companies that specialize in assuming reinsurance.

I am pleased to appear before you today to provide the reinsurance industry's perspective on regulatory reform. I commend Chairman Dodd and Ranking Member Shelby for holding this important hearing and welcome the opportunity to address the Committee about the current system for regulating the marketplace in light of recent developments in the financial markets. My testimony will highlight the function of risk management; how reinsurers doing business in the United States are regulated; why the current state-based insurance regulatory system does not work well for the sophisticated global reinsurance marketplace; the RAA's position in support of a single national regulator at the federal level for the reinsurance industry, or alternatively, federal legislation that streamlines the current state-based system; and the concept of a systemic risk regulator.

I. BACKGROUND ON REINSURANCE

a. The US Reinsurance Market

Reinsurance is critical to the insurance marketplace. It is a risk management tool for insurance companies to reduce the volatility in their portfolios and improve their 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 provide transfer for insurers of major natural and man-made catastrophe risk; and to increase insurance capacity.

Reinsurers have assisted in the recovery from every major US catastrophe over the past century. By way of example, 60% of the losses related to the events of September 11 were absorbed by the global reinsurance industry, and in 2005, 61% of Hurricanes Katrina, Rita and Wilma losses were ultimately borne by reinsurers.

Reinsurance is a global business. Encouraging the participation of reinsurers worldwide is essential to providing the much needed capacity in the US for both property and casualty risks. This can be best illustrated by the number of reinsurers assuming risk from US ceding insurers. In 2007, more than 2,500 foreign reinsurers assumed business from US ceding insurers. Those 2,500 reinsurers were domiciled in more than 70 foreign jurisdictions.[1] Although the majority of US premiums ceded offshore is assumed by reinsurers domiciled in ten countries, the entire market is required to bring much needed capital and capacity to support the extraordinary risk exposure in the US and to spread the risk throughout the world's financial markets. Foreign reinsurers now account for 56% of the US premium ceded directly to unaffiliated reinsurers; a figure that has grown steadily from 38% in 1997.

b. US Reinsurance Regulation – Direct and Indirect

US reinsurers are currently regulated on a multi-state basis. While the current state-based insurance regulatory system is primarily focused on solvency regulation with significant emphasis on regulating market conduct, contract terms, rates and consumer protection, reinsurance regulation focuses almost exclusively on ensuring the reinsurer's financial solvency so that it can meet its obligations to ceding insurers.

Reinsurance is regulated by the states utilizing two different methods: direct regulation of US-licensed reinsurers and indirect regulation of reinsurance transactions. States directly regulate reinsurers that are domiciled in their state, as well as those US reinsurers that are simply licensed in their state, even if domiciled in another state. These reinsurers are subject to the full spectrum of solvency laws and regulations to which an insurer is subject, including: minimum

[1] Reinsurance Association of America (RAA), Offshore Reinsurance in the US Market 2007 Data (2008)

capital and surplus requirements, risk-based capital requirements, investment restrictions, required disclosure of material transactions, licensing, asset valuation requirements, examinations, mandated disclosures, unfair trade practices laws, Annual Statement requirements and actuarial-certified loss reserve opinion requirements. Because the reinsurance transaction is between two sophisticated parties, there are no regulatory requirements relating to the rates that are negotiated between the parties or the forms used to evidence contractual terms.

There is also indirect regulation of reinsurance transactions through the credit for reinsurance mechanism, which is the financial statement accounting effect given to an insurer if the reinsurance it has purchased meets certain prescribed criteria. If these criteria are met, the insurer may record a reduction in its insurance liabilities for the effect of its reinsurance transactions. One of the most widely discussed criteria is the "collateral" requirement that a non-licensed reinsurer must either establish a US trust fund or other security in the US, such as a clean, irrevocable and unconditional letter of credit issued by an acceptable institution, to cover its potential liabilities to the insurer. This provision is based on the historic premise that state regulators do not have the regulatory capability or resources to assess the financial strength or claims paying ability of reinsurers that are not authorized or licensed in that state.

For several reasons, including the cumbersome nature of a multi-state licensing system, capital providers to the reinsurance market have in recent years opted for establishing a reinsurance platform outside the US and conducting business through a US subsidiary or by providing financial security through a trust or with collateral. Following the events of September 11, 2001, 12 new reinsurers with $10.6 billion capital were formed. After Hurricane Katrina, at least 38 new reinsurance entities with $17 billion of new capital were formed. Nearly all of this new capital came from US capital markets, yet no new reinsurer was formed in the United States. Other than the US subsidiaries of some of these new companies, not one US-domiciled reinsurer has been formed since 1989. For these startups, the ease of establishment, capital formation, and regulatory approvals in non-US jurisdictions contrasts with the cumbersome and protracted nature of obtaining licenses in multiple US states. We believe that a streamlined national US regulatory system will result in reinsurers conducting business more readily through US operations and US-based personnel.

II. KEY ISSUES FOR THE US REINSURANCE INDUSTRY

The RAA seeks to modernize the current regulatory structure and advocates a single national regulator at the federal level. Alternatively, the RAA seeks federal legislation that streamlines the current state-based system. There are a number of key problems and inefficiencies with the current state-based framework for reinsurance regulation.

a. The Need for a Single Federal Role

As has been noted by a variety of commentators, as well as the 2008 US Treasury Blueprint for Financial Regulatory Reform ("the Treasury Blueprint"), the US state-based insurance regulatory system creates increasing tensions in the global marketplace, both in the ability of US-based firms to compete abroad and in the allowance of greater participation of foreign firms in the US market. Foreign government officials have continued to raise trade barrier issues associated with dealing with 50 different US insurance regulators, which makes coordination on international insurance issues difficult for foreign regulators and companies.

An informed federal voice with the authority to establish federal policy on international issues is critical not only to US reinsurers, which do business globally and spread risk around the world, but also to foreign reinsurers, who play an important role in assuming risk in the US marketplace.

The fragmented US regulatory system is an anomaly in the global insurance regulatory world. As the rest of the world continues to work towards global regulatory harmonization and international standards, the US is disadvantaged by the lack of a federal entity with authority to make decisions for the country and to negotiate international insurance agreements, or alternatively, the lack of federal-enabling legislation which empowers a single state regulator to do so.

b. Mutual Recognition

US states impose a highly structured and conservative level of regulation on licensed reinsurers. However, it has long been recognized that there are several globally recognized methods of conducting reinsurance regulation.

The RAA was encouraged by the inclusion of a system of mutual recognition among countries in “The National Insurance Act of 2008” (S. 40), introduced in the last Congress. Mutual recognition seeks to establish a system where a country recognizes the reinsurance regulatory system of other countries and allows reinsurers to conduct business based on the regulatory requirements of its home jurisdiction. If such a system were established, European reinsurers would be permitted, for example, to assume reinsurance risk from the US without having to obtain a US license and without having a requirement in law to provide collateral for their liabilities to US ceding insurers. In return, such a system would allow US reinsurers to conduct business in the mutually recognized country based on US regulatory oversight.

A single national regulator with federal statutory authority could negotiate an agreement with the regulatory systems of foreign jurisdictions that can achieve a level of regulatory standards, enforcement, trust, and confidence with their counterparts in the US.

c. Extra-Territorial Application of Law

The RAA also believes there is a need for greater efficiency in the regulation of reinsurance in the US. As a result of our 50-state system of regulation, significant differences have emerged among the states with respect to reinsurance regulatory requirements. Multi-state systems add extra costs to transactions. These costs are ultimately reflected in the premiums paid by consumers. 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 the accreditation system; yet, this has not prevented some states from pursuing varying and sometimes inconsistent regulatory approaches. One of the best examples of this is the extra-territorial application of state laws.

Thirteen states apply at least some of their regulatory laws on an extra-territorial basis, meaning that the state law not only applies to the insurers domiciled in that state, but to insurers domiciled in other states if the extra-territorial state has granted a license to the insurer. For example, an insurer domiciled in a state other than New York, but licensed in New York, will find that New York asserts that its laws apply to the way it conducts its business nationwide. Since most US-based reinsurers are licensed in all 50 states, this extra-territorial application of state law results in inconsistencies among state laws.

As Congress proceeds to review the current regulatory structure and consider a new one for the future, we encourage the Committee to focus on streamlining reinsurance regulation to allow US reinsurers to be more competitive in the global marketplace, maximize capacity in the US, and make us a more attractive place for companies to locate their business. Any structure that is adopted should eliminate duplicative and inconsistent regulation like that which is caused by the extra-territorial application of state laws. Such a provision was included in the House-passed Nonadmitted and Reinsurance Reform Act of 2008, although it lacked the necessary enforcement authority.

III. GOALS OF EFFECTIVE REINSURANCE REGULATION AND CORE CHARACTERISTICS OF A REINSURANCE REGULATORY REGIME

As we move forward with modernization efforts, the goals of effective reinsurance regulation in the United States should be to promote:

1. Financially-secure reinsurance recoverables and capacity that protects the solvency of US ceding insurers.
2. A competitive and healthy reinsurance market that provides sufficient capacity to meet ceding insurers' risk management needs.
3. Effective and efficient national reinsurance regulation.

The core characteristics of an appropriate reinsurance regulatory structure that would assist in achieving these goals should include:

1. A single federal regulator or regulatory system for reinsurance with national regulatory oversight and the power to preempt conflicting or inconsistent state laws and regulations in an effective and efficient manner.
2. The single regulator's authority should provide for the recognition of substantially equivalent regulatory standards and enforcement in other competent regulatory jurisdictions.
3. The regulatory structure should support global capital and risk management, taking into account capital adequacy, assessment of internal controls, recognition of qualified internal capital models and effective corporate governance.
4. The regulatory structure should provide for financial transparency that encourages and supports the cedents' ability to assess counter-party credit risk, including information regarding the reinsurer's financial condition and the reinsurer's performance in paying covered claims.

5. Regulators should have access to all necessary financial information with appropriate provision for the confidentiality of that information, as currently provided for under state law and regulatory practice.
6. The regulatory structure should have an effective transition mechanism between the current system and any future regime that is consistent with these core characteristics. Absent mutual agreement of the parties, any reduction in existing collateral requirements should only apply prospectively.
7. The regulatory structure should utilize principles-based regulation where appropriate.

There are several different ways to address meaningful modernization. Changes to the current reinsurance regulatory structure to achieve these goals and core characteristics include, but are not limited to: (1) a federal regulator for reinsurance, or (2) federal legislation that streamlines and modernizes the current state system. Although the RAA prefers a federal regulator, the Nonadmitted and Reinsurance Reform Act, also called the surplus lines and reinsurance bill, passed twice by the House, is a good start, but could be augmented by the recent NAIC-endorsed reinsurance modernization framework. The RAA supports the NAIC proposal to modernize the US reinsurance regulatory system through a system of regulatory recognition of foreign jurisdictions, a single state regulator for US licensed reinsurers, and a port of entry state for non-US based reinsurers.

The NAIC has acknowledged that "in light of the evolving international marketplace, the time is ripe to consider the question of whether a different type of regulatory framework for reinsurance in the US is warranted." The proposed NAIC framework, if implemented appropriately, would, in the words of the NAIC, "facilitate cross-border transactions and enhance competition within the US market, while ensuring the US insurers and policyholders are adequately protected." Given the challenges of implementing changes in all 50 states and questions of constitutional authority for state action on matters of international trade, the NAIC's support for federal legislation to accomplish this proposed framework is encouraging.

IV. THE NEED FOR A SYSTEMIC RISK REGULATOR?

I urge Congress to move reinsurance regulatory modernization forward regardless of the ongoing debate about a systemic risk regulator—the subject of my concluding testimony.

If, as House Financial Services Committee Chairman Barney Frank indicated during a February 3 press conference, there is a preference for systemic risk regulation "covering all forms of financial activity," significant issues about a systemic risk regulator remain unanswered, including, but not limited to:

1. What are the criteria for defining entities or markets that present a systemic risk?
2. How broad will this regulator's authority be?
3. How will this regulator's powers interact with those of the prudential regulator?
4. To what extent will the systemic risk regulator present duplicative regulation?
5. How will US companies that are part of an international group headquartered outside the US be treated?
6. How will the systemic risk regulator coordinate with the other international regulators?

In general, property casualty insurers generate little counterparty risk and their liabilities are, for the most part, independent of economic cycles or other systemic failures. Even during the current financial turmoil, rating agency A.M. Best continues to maintain a stable outlook for the global reinsurance sector based on its sound underlying operating earnings generated over the most recent timeframe, strong underwriting discipline, and capital adequacy. While the reinsurance industry plays an important role in the financial system, it may not necessarily present a systemic risk. In its 2006 report, "Reinsurance and International Financial Markets," the Group of 30 found "no evidence" that the failure of a reinsurer "has given rise to a significant episode of systemic risk."

Reinsurance is an important part of the risk transfer mechanism of modern financial and insurance markets. Yet, there are clear distinctions between risk finance and management products that are relatively new financial tools developed in unregulated markets, and risk transfer products like reinsurance whose issuers are regulated and whose business model has existed for centuries. In the case of reinsurance, regulatory reform is necessary to improve its regulatory and market efficiency and maximize capacity in the US, but not to address the fundamental risk transfer characteristics of the product.

Those addressing the authority of a systemic risk regulator envision traditional regulatory roles and standards for capital, liquidity, risk management, collection of financial reports, examination authority, authority to take regulatory action as necessary and, if need be, regulatory action independent of any functional regulator. At a speech before the Council of Foreign Relations last week, Federal Reserve Board Chairman Ben Bernanke acknowledged that such a systemic regulator should work as seamlessly as possible with other regulators, but that "simply relying on existing structures likely would be insufficient."

As I noted earlier in my testimony, the purpose of reinsurance regulation is primarily to ensure the collectability of reinsurance recoverables and to maintain a method of accurate reporting of financial information that can be relied upon by regulators, insurers and investors. Because reinsurance is exclusively a sophisticated business-to-business relationship, reinsurance regulation is functionally different from insurance, and has other critically different characteristics: no rate or form regulation and no consumer protection because there is no legal relationship to insurance consumers. Reinsurance companies are already regulated in much the same way as is being proposed for the systemic risk regulator—financial reporting, risk-based capital analysis, examination, and regulatory authority to take action to address financial issues. If licensed in the US, reinsurers are regulated in this way by the various states. If domiciled in a non-US jurisdiction, reinsurers are similarly regulated in their home country. We are concerned the systemic risk regulator envisioned by some would be redundant with this system. This raises concerns that, without financial services and insurance regulatory reform, a federal systemic risk regulator would: (1) be an additional layer of regulation with limited added value; (2) create due process issues for applicable firms; and (3) be in regular conflict with the existing multi-state system of regulation.

V. FINANCIAL REGULATORY MODERNIZATION

Most, if not all participants in the dialogue about financial services modernization, acknowledge that most financial markets are global and interconnected. Federal Reserve Chairman Bernanke noted that the global nature of finance makes it abundantly clear that any reform in the financial services sector must be coordinated internationally. Among the financial services providers, no sector is more global in nature than reinsurance.

Should Congress proceed with broad financial services modernization, we ask that it be recognized that reinsurance is by its global nature different from insurance, and that the federal government currently has the requisite constitutional authority, functional agencies and experience in matters of foreign trade to easily modernize reinsurance regulation. We believe that multiple state regulatory agencies in matters of international trade are at best inefficient, pose barriers to global reinsurance transactions, and do not result in greater transparency.

It is the recommendation of the Reinsurance Association of America that reinsurance regulatory modernization be included in any meaningful and comprehensive financial services reform through the creation of a federal regulator having exclusive regulatory authority over the reinsurance sector so there is no level of redundancy with state regulation. This should occur whether or not a systemic risk regulator is included in financial services reform. Alternatively, Congress should create a single exclusive national regulator for reinsurance at the federal level, but retain a choice or option for companies to remain in the state system. We recommend further that any such financial reform incorporate authority for a system of regulatory recognition to facilitate cooperation and enforcement with foreign insurance regulators.

If the Congress should choose not to include reinsurance in broader financial services reform, we encourage the enactment of legislation along the lines of the NAIC's reinsurance modernization proposal to streamline the state system as it relates to reinsurance by federally authorizing a port of entry for foreign reinsurers and single-state financial oversight for reinsurers licensed in the US.

Should Congress proceed first with a systemic risk regulator and defer financial services modernization, we encourage the Committee to provide a road map for addressing reinsurance regulatory reform along the lines described in this testimony.

The RAA thanks Chairman Dodd, Ranking Member Shelby and members of the Committee for this opportunity to comment on regulation, and we look forward to working with all members of the Committee as it considers this most important issue.