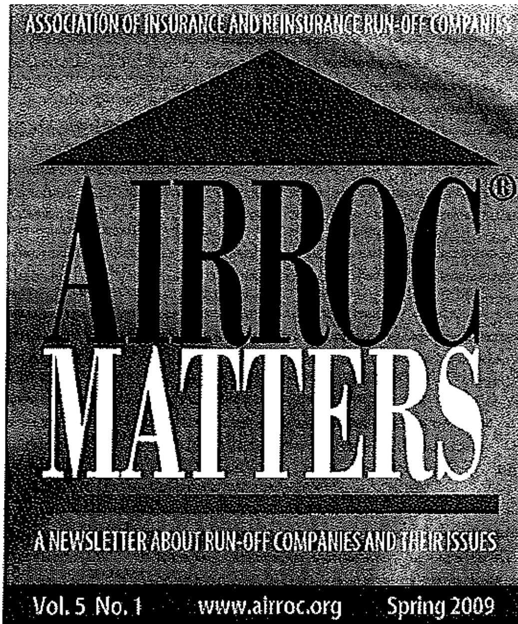

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Message from CEO and Executive Director

No Grass Growing Under This Rock

Trish Getty

By Trish Getty

Nearly five years after we planned its formation, the evolution of AIRROC has been quite interesting to observe. One of our initial goals was to create a venue where peers in the run-off industry meet on a regular basis. Our members have created relationships and developed friendships that allow them to address issues more easily and efficiently. This is one of the greatest values of AIRROC membership.

With respect to AIRROC membership, we ask for your assistance in recruiting new members. You conduct business with many companies, some of which would greatly benefit by membership. Please reach out to your contacts at these companies and relate your stories about AIRROC. If you find interest, please put me in contact with them (trishgetty@bellsouth.net). We all win when our membership is full and even more productive.

Our rock continues to roll as we propose initiatives that help run-off books of business to be concluded in a more cost-effective and efficient manner. One initiative, the AIRROC Dispute Resolution Procedure: An Alternative Designed for Small Claims, was rolled out by

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Reinsurance Relief from an Unlikely Source

William J. Brady

By William J. Brady

I. When it Rains it Pours

The higher costs associated with securing credit may soon be mitigated by the impending ratification of the National Association of Insurance Commissioners' ("NAIC") modernization regulations. For an industry that thrives on offsets, the NAIC's Modernization Plan regarding the loosening of collateral requirements for foreign insurance companies may help the reinsurance industry and its run-off sector in both the short and long term. A welcomed relief where everyday brings more doom and gloom from the financial sectors.

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The past eighteen months have been anything but boring in terms of the reinsurance industry. It took some time, but the sub-prime mortgage disaster in the United States and subsequent global credit crunch are rippling throughout the industry. The result has been that companies, regardless of size or stature, must readjust the way they do business from top to bottom. Banks are tightening their purse strings and charging higher costs for credit in both the insurance and reinsurance sectors. According to Aon Benfield, reinsurance capital was down anywhere between 15-20% in 2008. Given the start to 2009, reinsurance capital will likely take a further beating during the first quarter. Institutional lenders, now finding themselves in the crosshairs of Congress, must demonstrate that they are lending to well-documented and responsible borrowers. Of course, this article presupposes that banks are in fact lending again at pre-crisis levels. As a result of tightening credit, increased financial scrutiny is also making its way down from boards to management as employees at all levels must justify their existence in the current financial climate.

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Adding insult to injury, 2008 was also the second costliest year on record for catastrophe claims. Hurricanes Ike and Gustav helped contribute to $50 billion in man-made and industry catastrophe losses. In response, State Farm Property and Casualty, with losses of around $20 million a month, is pursuing its exit strategy from the Sunshine (Hurricane) State by 2011. This decision is a direct result of the Florida state government's refusal to allow a 47% increase in homeowner rates necessary to meet current and future losses. As far as man-made and catastrophe losses for 2009, Australian wildfires and two U.S. plane crashes mean that first quarter 2009 losses are unfortunately picking up where 2008 left off. Given the above, companies have every reason to bury their heads in the sand and hope for the best. However, the NAIC's recent regulations may be coming at an opportune time for the industry.

II. NAIC Modernization Framework

Just as increased government scrutiny is finding its way into the credit market, the NAIC is in the final stages of adopting its Reinsurance Regulatory Modernization Framework Proposal. In order to be finalized, Congress will have to adopt enabling act legislation. However, this step should be a mere formality and not a major hurdle towards ratification. It has taken a number of years and countless cries from abroad, but under the new plans, foreign reinsurance companies would be required to post collateral in the form of cash, bond or letter of credit commensurate with their newly assigned credit rating. This new development would be a welcomed relief from the 100% collateral requirement currently in place for foreign reinsurers, regardless of their stature or credit rating.

Under the new regulation, reinsurers would be classified either as domestic or foreign reinsurers. Foreign reinsurers, also referred to as "Port of Entry" reinsurers ("POEs"), are defined as a reinsurer organized in a non-U.S. Jurisdiction. In conjunction with the new classifications, the NAIC would also create the "Reinsurance Supervision Review Department" ("RSRD"). The RSRD would be responsible for certifying the POE before it can begin placing business within the U.S. In addition to certifying POEs, the RSRD would also be responsible for reviewing the POE's financials and, if necessary, adjust its rating/collateral requirement accordingly. While increased scrutiny in the lending market may increase costs for borrowers, increased RSRD scrutiny and cooperation with foreign reinsurers may have the opposite effect. Upon certification, companies would then have complete access to the entire U.S. market while remaining subject to the requirements of its port of entry state. Finally, in order to qualify as a POE, companies must also maintain a minimum capital and surplus requirement of $250 million. Otherwise the 100% collateral requirement remains in effect. As indicated in the International Association of Insurance Supervisor's 2007 Paper on the "Mutual Recognition of Reinsurance Supervision," some of the benefits of mutual recognition should include increased market capacity, reduced compliance costs, increased allocation of capital and greater levels of transparency. These benefits are a welcome sign given the uncertainty of the current economic climate.

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Companies who do not qualify under the sliding scale system must maintain the current 100% collateral requirement on assumed business. The RSRD will assign credit ratings as follows: POE Companies with the highest grades from rating agencies are deemed Secure-1 and need not post collateral. On the other end of the scale, POE companies rated Vulnerable-5 must adhere to the 100% collateral requirement. Companies rated Secure 2, 3, 4, would respectively post collateral at rates anywhere between 10% to 75% respectively.

Under the current requirements, high barriers of entry allow a finite number of reinsurers to dictate the market and set rates. However, the new system will almost certainly lead to an increase in the number of foreign reinsurers that otherwise would not be doing business in the U.S. given the current 100% collateral requirement. As the numbers of foreign reinsurers entering the U.S. through their port of entry state, cedants should find greater reinsurance options and more competitive pricing. As a corollary, risk managers can choose between companies deemed Secure-1 or choose companies with lower credit ratings. As risk managers select reinsurers with lower ratings, cedents will have to make difficult choices when choosing between lower premiums and security.

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Reinsurance Relief from an Unlikely Source *continued from Page 7*

However, these most recent developments do not come without potential drawbacks. Selecting reinsurers based upon their new RSRD rating are decisions previously unnecessary under the 100% collateral requirement system and would be a strain on already over-worked risk managers. Nevertheless, these choices are not completely unfamiliar and are often contemplated on a daily basis regardless of the new plan.

III. An Unlikely Offset?

Given the above framework, Reinsurers should not have as much capital tied up by the current U.S. collateral requirements. Naturally, this money can be earmarked for writing more policies or paying down the increased costs for credit. Since lenders will have to charge higher costs of capital, companies will welcome any area where these costs can be mitigated.

IV. New Regulations Impact on the Run-Off Sector

As discussed above, the new NAIC modern framework should bring lasting benefits to the live reinsurance industry. However, questions remain as to what happens when reinsurers enter run-off or what the net impact will be on companies currently operating within the run-off sector. To date, not much is known about run-off's new role under the Modernization Framework. Under the new framework, reinsurers operating under solvent schemes of arrangement or similar procedures involving U.S. Cedents will receive Vulnerable -5 ratings and be required to post 100% collateral (a completely familiar scenario for foreign reinsurers operating under the current system). The RSRD should begin making its first recommendations in approximately three years. Therefore, issues unique to the run-off sector should be forthcoming.

...within the run-off sector, companies can use the new ratings to evaluate claims and determine whether it may be most effective to deal with difficult reinsurers internally or to hire third-party service providers.

Where run-off could immediately benefit under the new modernization plan is the credit rating system assigned to reinsurers by the RSRD. According to the new NAIC plan, a company's ratings will be partially based on how slow they pay claims. Given the limited number of resources available to companies within the run-off sector, companies can use the new ratings to evaluate claims and determine whether it may be most effective to deal with difficult reinsurers internally or to hire third-party service providers. These difficult reinsurers will also be easier to spot based upon newly assigned RSRD ratings and not by reputation only. Difficult companies may also be keen to improve on their RSRD rating and possibly accelerate future payments.

V. Conclusion

While it is difficult to predict the future even in the stablest of financial times, the NAIC modernization framework is cause for optimism for the future of the U.S. reinsurance industry. Given the current climate, the possibility of good news in the immediate future should be cause for celebration. ■

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And because we enjoy a "government of laws and not of men" (and since it's neat to do something new), we introduce in this edition "Legalese," a new section that features articles discussing recent cases, statutes or other legal developments that relate to or impact run off. Our first installment comes from a return author, **Philip J. Loree Jr.** of Loree & Loree, entitled *KX Reinsurance Co. v. General Reinsurance Corp.: Can Arbitrators Retain Jurisdiction After Resolving All Submitted Issues?*

Sprinkled with our favorite toppings, **Trish Getty's** *No Grass Growing Under This Rock*, and **Nigel Curtis'** *Present Value* and *KPMG Policyholder Support Update*, your run off dessert is ready!

With all this shakin' going on, AIRROC Matters covers your world...

Let us hear from you. ■

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