The Florida Senate

Issue Brief 2011-202 *November 2010*

Committee on Banking and Insurance

IMPACT OF FEDERAL LEGISLATION ON REINSURANCE LAWS IN FLORIDA

Statement of the Issue

On July 21, 2010, the federal Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (act)[1] was signed into law. Provisions contained in Title V of the act that relate to the Federal Insurance Office, nonadmitted insurance, and reinsurance take effect 12 months after the enactment date, July 21, 2010. The act affects almost every segment of the U.S. financial services industry. With respect to insurance provisions, the act establishes national standards on how states will regulate nonadmitted insurance and reinsurance.

In Florida, the Office of Insurance Regulation (OIR) is responsible for regulating and licensing insurers and other risk-bearing entities. Regulatory oversight includes licensure, approval of rates and policy forms, market conduct and financial exams, solvency oversight, and administrative supervision as provided in the Florida Insurance Code.

Reinsurance is the transfer of risk initially underwritten by one insurer (the direct writer) to another insurer (the reinsurer). In the property insurance market, it is purchased to cover catastrophic losses that exceed what the direct writer could finance on its own. Reinsurance serves multiple functions, safeguarding the solvency of direct writers by ensuring they can withstand wind losses, enabling them to provide coverage for relatively high-risk policies and to write more policies than they would otherwise be able.

This issue brief summarizes key provisions of the recently enacted federal Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 and relevant provisions of the Insurance Code regulating reinsurance.

Discussion

Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010

Insurance companies comprise a major segment of the U.S. financial services industry. Consolidations in the insurance industry are creating large multinational entities. In response to the growing, global insurance market, the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 contained the Nonadmitted and Reinsurance Reform Act of 2010, which addressed the regulation of nonadmitted insurance and reinsurance and the establishment of a Federal Insurance Office.

Generally, under the federal McCarran-Ferguson Act of 1945, insurance regulation is state based.[2] Although the Dodd-Frank Wall Street Reform and Consumer Protection Act enacted in 2010 does not implement a federal regulatory system for insurance, Title V of the act increases the federal government's oversight and authority related to specified insurance activities, including reinsurance transactions.

The act creates a Federal Insurance Office (office) within the Department of the Treasury. The office is authorized to monitor all aspects of the insurance industry with some exceptions,[3] and to coordinate and develop policy relating to international agreements. The monitoring duties of the office include gathering data from the public

[1] P.L. 111-203.
[2] 15 USC Sec. 1011 *et seq*.
[3] The authority of the Federal Insurance Office extends to all lines of insurance except for health insurance, long-term care insurance, and crop insurance.

and private sectors. The office may consult with states, including state regulators, regarding insurance matters of national and international importance. The office is required to submit to Congress the following:

- A report describing the scope of the global reinsurance market and the critical role such market plays in supporting insurance in the U.S. (no later than September 30, 2012);
- A report describing the impact of part II of the Nonadmitted and Reinsurance Reform Act of 2010 on the ability of state regulators to access reinsurance information for regulated companies in their jurisdiction (no later than January 1, 2013); and
- A report on how to modernize and improve the system of insurance regulation in the U.S. (no later than 18 months after the enactment of Title V).

Regulation of Credit for Reinsurance and Reinsurance Agreements

The intent of the reinsurance provisions is to maintain the competitive positions of insurers and reinsurers in the global market by standardizing, or in some cases, reducing regulation. With respect to reinsurance transactions, the act would designate the domicile state of the insurer purchasing the reinsurance with the authority over the transaction while vesting the home state of the reinsurer with the sole authority to regulate the solvency of the reinsurer. As a result, a ceding insurer would only have to comply with the laws of one state. This provision would benefit foreign companies that provide reinsurance within the U.S.

Specifically, the act requires that, if the domicile state of a ceding insurer is an NAIC-accredited state,[4] or has financial solvency requirements substantially similar to the requirements necessary for NAIC accreditation, and recognizes credit for reinsurance[5] for the insurer's ceded risk, then no other state may deny such credit for reinsurance. In addition, the federal act also provides that laws of a state that is not the domicile state of the ceding insurer, except those with respect to taxes and assessments on insurance companies or insurance income, are preempted to the extent that they:

- Restrict or eliminate the rights of the ceding insurer or the assuming insurer to resolve disputes pursuant to contractual arbitration;
- Require that another state's law will govern the reinsurance contract, disputes arising from the reinsurance contract, or requirements of the reinsurance contract;
- Attempt to enforce a reinsurance contract on terms different than those set forth in the reinsurance contract, to the extent that the terms are not inconsistent with Part II of Title V; or otherwise
- Apply the laws of the state to reinsurance agreements of ceding insurers not domiciled in that state.

Regulation of Reinsurer Solvency

If the domicile state of a reinsurer is an NAIC-accredited state or has financial solvency requirements substantially similar to the requirements necessary for NAIC accreditation, such state is solely responsible for regulating the financial solvency of the reinsurer. Non-domiciled states are prohibited from requiring the reinsurer to provide any additional financial solvency information other than information the reinsurer is required to submit with its domicile state.

Clarification of Intent of the Federal Provisions

Rep. Dennis Moore, one of the chief House sponsors of this act, submitted a Clarification of Intent with respect to Title V of the act to the House of Representatives on July 30, 2010.[6] In this statement, he provided the following clarifications of the intent of Title V of the act:

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[4] The National Association of Insurance Commissioners (NAIC) is an organization of insurance regulators from the 50 states, the District of Columbia, and the five U.S. territories. The NAIC provides a forum for the development of uniform policy when uniformity is appropriate.

[5] The act defines the term, “reinsurance,” to mean the assumption by an insurer of all or part of a risk undertaken by another insurer.

[6] Congressional Record, H.R. 4173, the Dodd-Frank Wall Street Reform and Consumer Protection Act Clarification of Intent with Respect to Title V (Extension of Remarks), E1505, July 30, 2010.

- With respect to Sec. 533(5) of the Dodd-Frank Act, the definition of ''reinsurer'' is not to be construed narrowly, thereby limiting or avoiding the intent of Congress with respect to Title V, Subtitle B, Part II.
- Additionally, Sections 531 and 532 of the Dodd-Frank Act entitled ''Regulation of Credit for Reinsurance and Reinsurance Agreements'' and ''Regulation of Reinsurer Solvency,'' respectively, are also not to be construed narrowly so as to limit or avoid the intent of Congress with respect to Title V, Subtitle B, Part II. Furthermore, the clear intent of Section 532 in the manner it is written and should be understood is that the regulation of reinsurer solvency, pursuant to the Dodd-Frank Act, includes the NAIC Financial Regulation Standards and Accreditation Program's laws and regulations.
- Finally, in order to ensure the states are appropriately implementing the Nonadmitted and Reinsurance Reform Act, it is the intent of Congress that the Study and Report on Regulation of Insurance required pursuant to Title V, Subtitle A, Sec. 502 of the Dodd-Frank Act include an evaluation of each state's compliance with Title V, Subtitle B.

National Association of Insurance Commissioners

Accreditation

Although each state regulates the insurance industry within its boundaries, many states often voluntarily create and enact uniform legislation. The NAIC is a voluntary association of insurance regulators from all 50 states. The NAIC was created to coordinate regulation of multistate insurers, provide a forum for addressing major insurance issues, and promote consistent laws among the states. The NAIC also has a national accreditation program of reviewing state insurance departments, serves as a national insurer information clearinghouse, provides a structure for interstate cooperation in examining multi-state insurers, and develops model laws. A state may accept an examination report on a company prepared by the company's state of domicile if the state insurance department was accredited at the time of the exam, or the exam was performed under the supervision of an accredited insurance department or by at least one examiner who is employed by an accredited department. The accreditation standards require that insurance departments have adequate statutory and administrative authority to regulate an insurer's corporate and financial affairs, and that they have the necessary resources to carry out that authority. As a condition of accreditation, a state must adopt laws or regulations that codify certain NAIC model laws and regulations or provisions that are substantially similar. NAIC initially accredited Florida in December 1990, and reaccredited Florida in December of the following years: 1998, 2003, and 2008.

Reinsurance Model Laws and Regulations

Currently, the NAIC models 785 (Credit for Reinsurance Model Law), 786 (Credit for Reinsurance Model Regulation), and 790 (Reinsurance Intermediary Model Act) are required for accreditation purposes. During the last few years, the NAIC Reinsurance Task Force has been developing a reinsurance regulatory modernization framework to streamline regulation of reinsurers. This framework or model would allow a state with the appropriate regulatory capacity to be the sole U.S. regulator of a reinsurer that is writing assumed business in the U.S., if certain conditions are met. In addition, reinsurers would be subject to minimum capital and surplus requirements, and collateral requirements. Subsequent to the passage of the federal act, the task force also has met to discuss the impact of the act on the regulation of reinsurance and revisions to the model laws and regulations.

Regulation of Reinsurance in Florida

The OIR requires insurers to maintain sufficient reserves and reinsurance to withstand losses and ensure solvency. Under current law, a new property insurer must have $5 million in surplus as to policyholders upon application for a certificate of authority and must maintain the greater of $4 million or 10 percent of its total liabilities thereafter.[7] A property insurer's written premium to surplus ratio must not exceed 4 to 1 for net written premiums or 10 to 1 for gross written premiums.[8] [9]

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[7] Sections 624.407(1)(a), 624.408(1)(a), F.S.
[8] Net premiums are equal to gross premiums minus reinsurance premiums ceded.
[9] Section 624.4095(1), F.S.

On April 12, 2010, the OIR issued an Informational Memorandum eliminating the requirement for a property insurer to purchase a specific level of catastrophic reinsurance.[10] According to the memorandum, the OIR no longer would require any specific level of catastrophe reinsurance, such as the 1 in 100 probable maximum loss level. Instead, the OIR "…will look at the entire spectrum of catastrophe risk for each insurer recognizing it is important to protect the surplus of the insurer from multiple storms of a small magnitude." The memorandum also directed property insurers to retain some of the catastrophe risk; however, the insurers should limit retention of risk per storm that exceeds approximately half of the surplus above the legally required minimum.

Current statutory accounting provides insurers with a credit for reinsurance as either an asset or a deduction from liability because of reinsurance ceded or transferred only if the reinsurance meets certain specified conditions, as provided in s. 624.610, F.S. For example, no credit is authorized for reinsurance if the reinsurance agreement does not create a meaningful transfer of risk of loss to the reinsurer.[11] For statutory accounting purposes, risk consists of underwriting risk and timing risk.[12] If these elements do not exist, reinsurance accounting treatment is not allowed under the NAIC statutory accounting principles and model regulations.[13]

Section 624.610(14) authorizes the Financial Services Commission[14] to adopt rules implementing the provisions of s. 624.610, F.S. These rules are required to be in substantial compliance with the NAIC model regulations relating to credit for reinsurance and the NAIC Accounting Practices and Procedures Manual.

Credit for reinsurance is allowed when the reinsurance is ceded to an assuming insurer that is authorized to transact insurance or reinsurance in Florida. In order to be an eligible reinsurer, a reinsurer must meet the following requirements:

- File with the OIR evidence of its submission to this state's jurisdiction;
- Submit to this state's authority to examine its books and records;
- Is licensed or authorized to transact insurance or reinsurance in at least one state, or in the case of a U.S. branch of an alien assuming insurer, is entered through, licensed, or authorized to transact insurance or reinsurance in at least one state;
- File with the OIR a copy of its annual statement filed with the insurance regulator of its state of domicile and a copy of its most recent audited financial statements; and
- Maintain a surplus in an amount not less than $20 million and have accreditation that has not been denied by the OIR within 90 days after its submission; or maintain a surplus in an amount not less than $20 million and have accreditation has been approved by the OIR.[15]

[10] Informational Memorandum (OIR-10-01M), Notice on Catastrophe Insurance, April 12, 2010.
[11] Section 624.610(13), F.S.
[12] Statement of Statutory Accounting Principles (SSAP) No. 62R, Property and Casualty Reinsurance, of the NAIC Accounting Practices and Procedures Manual, December 5, 2009.
[13] According to SSAP No. 62R, "The essential ingredient of a reinsurance contract is the transfer of risk. The essential element of every true reinsurance agreement is the undertaking by the reinsurer to indemnify the ceding entity, i.e., reinsured entity, not only in form but in fact, against loss or liability by reason of the original insurance. Unless the agreement contains this essential element of risk transfer, no credit shall be recorded." Further, a reasonable possibility must exist that the reinsurer may sustain a significant loss from the transaction.
[14] The Financial Services Commission, consisting of the Governor and the Cabinet, is the agency head for purposes of rulemaking for the OIR. [s. 20.121, F.S.]
[15] Section 624.610(3), F.S.