Emerging Issues in U.S Insurance and Law

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- Fred E. Karlinsky, a shareholder in Colodny, Fass, Talenfeld, Karlinsky and Abate in Fort Lauderdale and Tallahassee, focuses his practice on insurance regulatory matters, insurance legislative matters, insurance transactional matters and governmental affairs.
- An “AV” rated Martindale Hubbell attorney, Mr. Karlinsky was named to Florida Trend Magazine’s Florida Legal Elite in 2005 and 2006, named as a Top Lawyer by the South Florida Legal Guide for 2005, 2006, and 2007, and selected as a Super Lawyer and featured in the 2007 Florida Super Lawyer Magazine.

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PROFESSIONAL BIOGRAPHY OF FRED E. KARLINSKY

- Mr. Karlinsky is a member to the Florida Bar and admitted to practice in all Florida state and appellate courts, the United States District Court for the Southern, Middle and Northern Districts of Florida, the United States Court of Appeals for the 11th Circuit, the United States Court of Federal Claims, the United States Tax Court and the United States Supreme Court.

- Mr. Karlinsky is a member of the American Bar Association, American Corporate Counsel Association, Miami-Dade County Bar Association, Broward County Bar Association, Tallahassee Bar Association and the Florida Academy of Professional Mediators and previously was a member of the Florida Bar Judicial Evaluation Committee (1999-2004).

- Mr. Karlinsky is a Certified Mediator for Circuit Civil and County Court, a Guardian Ad Litem and a Florida Department of Insurance Certified Continuing Education Instructor.

PROFESSIONAL BIOGRAPHY OF FRED E. KARLINSKY

- Mr. Karlinsky currently serves as Florida counsel to the Property Casualty Insurers Association of America (PCI), general counsel and chief lobbyist for the Florida Property and Casualty Association (FPCA) and lobbyist for the Florida Association of Health Underwriters (FAHU) among other clients.

- Mr. Karlinsky's professional memberships include the Association of Insurance Compliance Professionals (AICP), International Association of Insurance Receivers (IAIR), Federation of Regulatory Counsel (FORC), Business Services Member of the American Association of Managing General Agents (AAMGA), and the Gerson Lehrman Group Council.

- Mr. Karlinsky is a graduate of the University of Miami (B.S., 1989) and Florida State University College of Law (J.D., 1992).

DISCLAIMER

The materials in this presentation are intended to provide a general overview of the issues contained herein and are not intended nor should they be construed to provide specific legal or regulatory guidance or advice. If you have any questions or issues of a specific nature you should consult with appropriate legal or regulatory counsel to review the specific circumstances involved.

AGENDA

Emerging Issues

- Possible Repeal of the McCarran-Ferguson Act
- Dual Regulatory System
  - State Modernization and Regulatory Transparency Act (SMART)
  - National Insurance Act
  - State Insurance Authority Study
- Nonadmitted and Reinsurance Reform Acts
- Surplus Lines Compact
- Reinsurance Regulatory Framework
- Terrorism Risk Insurance Acts

AGENDA

- National Catastrophe Fund
- National Flood Insurance Program
- Wind Insurance Vs. Flood Insurance
- Contingent Commissions
- Finite Reinsurance

POSSIBLE REPEAL OF MCCARRAN-FERGUSON ACT

- The McCarran-Ferguson Act was passed by Congress in 1945 after a Supreme Court ruling in *U.S. v. South-Eastern Underwriters* that held that insurance could be regulated by the federal government.

- Congress passed the Act to provide that state laws and regulations that regulate the "business of insurance" may not be preempted by federal law.

- It provides, in essence, that insurance shall be regulated by the states rather than the federal government.

POSSIBLE REPEAL OF MCCARRAN-FERGUSON ACT

- Under the Act, insurance is exempt from some federal antitrust statutes.
- This exemption primarily allows insurers to gather and share loss data.
- Insurers remain subject to other federal and state antitrust laws.
- The insurance industry contends that this antitrust exemption helps small and medium-size insurance companies compete by allowing them to gain access to loss data which their more limited claims experience would not normally provide them.
- This in turn helps stimulate competition in the industry by opening markets to smaller and medium sized insurers.

POSSIBLE REPEAL OF MCCARRAN-FERGUSON ACT

- The insurance industry further contends that McCarran-Ferguson helps keep the cost of doing business down by preventing class action lawsuits based on alleged antitrust violations.

- Senators Patrick Leahy (D-VT), Arlen Specter (R-PA), Trent Lott (R-MS), Harry Reid (D-NV) and Mary Landrieu (D-LA) introduced the Insurance Industry Competition Act of 2007 (S. 618) in the Senate on February 15, 2007.

- Since Hurricane Katrina, Senators Leahy and Lott have been critical of the insurance industry's practices.

POSSIBLE REPEAL OF MCCARRAN-FERGUSON ACT

- The companion bill, House Bill 1081, was introduced by Pete DeFazio (D-OR), Gene Taylor (D-MS), Bobby Jindal (R-LA), Charlie Melancon (D-LA), Rodney Alexander (R-LA) and Walter Jones (R-NC) on February 15, 2007, but has not been heard in any committee to date.

- Effectively, these bills would repeal the limited exemption from federal antitrust laws granted to the insurance industry by the McCarran-Ferguson Act in 1945.

POSSIBLE REPEAL OF MCCARRAN-FERGUSON ACT

- The insurance industry contends that this legislation would reduce competition, create more litigation, increase the cost of doing business and drive up the cost of insurance to the public.

- Several industry groups including the Property Casualty Insurers Association of America (PCI), the National Association of Professional Surplus Lines Offices (NAPSLO), the Professional Insurance Agents (PIA), the American Insurance Association (AIA) and the American Council of Life Insurers (ACLI) have spoken out loudly against the bills.

POSSIBLE REPEAL OF MCCARRAN-FERGUSON ACT

- At the NAIC's recent meeting in San Francisco, CA, John Lobert, Senior Vice President of Government Affairs for PCI said, "McCarran-Ferguson is the lynchpin to state-based insurance regulation and state regulators can be very effective in making the case for the limited antitrust exemption."

- The National Conference of State Legislatures (NCSL) passed a resolution at its August annual meeting in opposition to the partial repeal of McCarran-Ferguson, which was supported by the Independent Agents & Brokers of America (The Big "I").

- It does not appear that either of these bills will pass the House or Senate.

DUAL REGULATORY SYSTEM

- State Modernization and Regulatory Transparency Act (SMART)
- National Insurance Act
- State Insurance Authority Study

SMART

- Although the State Modernization and Regulatory Transparency Act (SMART) has only been circulated as a discussion draft, there remains the possibility that SMART, or some variation thereof, may reappear as a bill in Congress.

- For that reason it is wise to be familiar with the basic components of the legislation.

SMART

- SMART was originally proposed as draft legislation by former U.S. Representative Mike Oxley (R-OH), former Chairman of the House Financial Services Committee, and Representative Richard Baker (R-LA), Chairman of the House Financial Services Subcommittee on Capitol Markets, Insurance and Government Sponsored Enterprises.

- A bear of a bill:
  - 17 separate titles
  - 500 pages of legislative text
  - Addressed a full range of insurance regulatory issues including:
    - Market conduct
    - Licensing
    - Product and rate approval

SMART

- SMART would not involve federal regulation.
- However, the states would be required to adopt certain uniform standards related to insurance and there would be a mechanism to force states to comply.
- A federal regulator would be involved to oversee solvency and market conduct.

SMART

Key provisions in the bill address:

- Market Conduct and Uniform Standards
- Insurer Licensing
- Producer Licensing
- Commercial Property and Casualty Insurance
- Creating Competitive Insurance Markets

SMART

Market Conduct and Uniform Standards

- States must develop and coordinate uniform market conduct oversight that is consistent, reliable, transparent and focuses resources on patterns of abuse.
- States required to implement:
  - System for implementing market conduct examinations of multi-state insurers;
  - Uniform procedures regarding "for cause" market conduct examinations;

SMART

- Transparent and published standards for all state market conduct rules or regulations;
- Uniform market conduct laws, procedures and practices so that states can rely on each other's oversight; and,
- Coordinate requests for market conduct analysis and examination information.

SMART

Insurer Licensing

- States required to develop a single point-of-entry for company licensing based on:
  - Adequate standards; and,
  - Use of uniform electronic application filing system.

- States required to streamline insurance company licensing that allows a company in good standing in a model state to submit a uniform application and Certificate of Authority electronically to receive license in other states.

SMART

Producer Licensing

- States required to implement reciprocal licensing for agents and brokers within two years.
- Within three years, states required to:
  - Streamline licensing standards and increase uniformity;
  - Eliminate discriminatory requirements and excessive continuing education burdens imposed against nonresidents;

SMART

- Implement the NAIC's National Producer Licensing Database for coordinated licensing of agents and brokers;
- Adopt coordinated electronic filing license application; and
- Adopt uniform insurer appointment standards and procedures.

SMART

Commercial Property and Casualty Insurance

- Within three years, states required to achieve:
  - Coordinated electronic system for nationwide single-point filing of policy forms; and,
  - Updated standards for product filing, including either NAIC model law or regulations providing:
    - Competitive rating with expedited rate filings;
    - Expedited policy form review;

SMART

- Recognition of single-state governance of policy form requirements based on primary location of policy risk and consumer's place of business;
- Recognition of qualified exempt commercial policyholders whose insurance is not subject to rate and form review;
- Common nomenclature to reduce unnecessary form filing deviations and coordinate filing reviews; and,
- Greater transparency in rates and forms regulation through elimination of unpublished desk drawer rules.

SMART

Surplus Lines and Independently Procured Insurance

- Any tax obligations related to surplus lines or directly procured insurance should be:
  - Required to be paid only in home state of insured;
  - Allocated among the states according to allocation formula and procedure to be developed; and,
  - Processed through a uniform and centralized national electronic system.

SMART

- Surplus lines should be streamlined and modernized in the following respects:
  - All states should participate in NAIC's National Insurance Producer Database for licensure and renewal of licenses;
  - States should develop a uniform set of eligibility criteria for non-admitted insurers; and,
  - Regulation of surplus lines transactions regarding sophisticated commercial purchasers should be streamlined.

SMART

Creating Competitive Insurance Markets

- After two years, no state may require approval or prior review of any rate charged for an insurance policy by an insurer;
- A flexband phase will be incorporated for covered lines to phase in competitive rating; and,
- States may still require informational filing of rates.

SMART

- Several insurance organizations have expressed their opposition to SMART.
- Among those organizations are the National Conference of Insurance Legislators (NCOIL) and the NAIC.

SMART

NCOIL

- The NCOIL Executive Committee voiced their concerns with the SMART Act in a letter to former U.S. Representative Oxley and Representative Baker.
- Among other things, the Executive Committee stated that SMART, as currently drafted, would:
  - Undermine the role of state legislatures in the development of insurance public policy;

SMART

- Undermine the authority of state insurance commissioners, who are elected in no less than 12 states, two of those states being the most populous in the nation, as well as undermine the authority of state insurance commissioners who are duly appointed by their elected governors;

- Impose on taxpayers and consumers the costs of a new quasi-federal entity that will very likely evolve into a federal regulatory body;

- Nullify and preempt many state insurance statutes that were enacted after input from consumers and businesses and after thoughtful consideration by state legislatures; and,

SMART

- Hand over unprecedented legislative authority to the NAIC, a non-governmental organization not directly accountable to voters, which would:
  - Violate state sovereignty to make laws;
  - Nullify the state authority that now exists under the McCarran-Ferguson Act and require amendments of the Act in order to eliminate a legislative anomaly;
  - Impair the flexibility of states to respond to specific marketplace issues resulting from geography, demographics and consumer need; and,
  - Impose overall Federal authority over insurance even though it is only warranted on issues that are national in scope, such as terrorism and natural disaster insurance.

SMART

NAIC's Reaction to SMART

- The NAIC's Government Affairs Task Force undertook a detailed analysis of SMART.
- The NAIC created seven review teams to evaluate and issue separate reports on each title of SMART.
- The NAIC review teams were comprised of 117 commissioners and senior regulatory experts from state insurance departments and the NAIC.

SMART

Summary of Key Findings by the NAIC SMART Review Teams

- SMART would substantially and negatively impact state regulatory authority to supervise property/casualty, life and health insurance, as well as reinsurance, by establishing federally-mandated standards and preempting state laws.
- As a result, insurance consumers would be denied the benefits of important state consumer protection laws and regulations.

SMART

- SMART would create regulatory confusion in insurance markets by :
  - Subjecting state regulatory authority to second-guessing and possible interference by the State-National Insurance Coordination Partnership;
  - Raising a host of legal and practical concerns regarding its composition, powers and administration, and encourage time-consuming and expensive litigation by persons who disagree with state regulatory actions; and,
  - The legitimacy of state actions would hang under a cloud of doubt until a final resolution was reached in federal courts, causing uncertainty in the marketplace.

SMART

- SMART would remove the ability for independent judgment and action by state regulators to protect consumers under state laws and regulations in areas such as supervising rates and conducting market conduct exams;
- In Illinois, cited by SMART proponents as the model rate system for all states, the Act would undercut or negate provisions of state law that make the Illinois rate system work;
- Time limits for states to implement the Act's requirements are unrealistically short; and,
- Many of the Act's provisions seem unworkable or detrimental to state consumer protection efforts.

SMART

- Federal legislation is generally not needed to implement the various provisions of the NAIC's Roadmap for regulatory modernization.
- However, the NAIC welcomes federal legislation that would:
  - Permit equal access by all state insurance regulators to the FBI's criminal database;
  - Enable sharing of confidential regulatory information; and,
  - Grant states equal receivership powers with the federal government.

NATIONAL INSURANCE ACT

- On May 24, 2007, the National Insurance Act of 2007 (S. 40) was introduced in the Senate by Senator Tim Johnson (D-S.D) and Senator John Sununu (R-N.H). Companion legislation was introduced in the House by Representative Melissa Bean (D- Ill.) and Representative Ed Royce (R-Cal.).

- Similar to the legislation introduced in 2006, the 2007 Senate bill proposes a new federal role in insurance regulation which is based on the dual banking regulatory system.

- Under the Senate bill, insurers operating under multiple state jurisdictions could choose to be regulated at the national level under a new "Optional Federal Charter".

NATIONAL INSURANCE ACT

- The bill provides that insurers and producers would be free to elect federal or state regulation, charters and licenses.
- The bill provides that all states would maintain responsibility of regulating state-licensed insurers and producers.
- Under the bill, a national agency would be authorized to sell insurance for any federally chartered or state-licensed insurer.
- Unlike the bill introduced in 2006, the 2007 bill addresses the surplus lines market, by clearly defining non-admitted and surplus lines insurance.

NATIONAL INSURANCE ACT

- Specifically, the bill allows nationally licensed agencies to engage in the placement of policies issued by surplus and non-admitted insurers.
- Under the bill, a federally licensed insurance producer could sell insurance, including surplus lines insurance, in any state on behalf of any national insurer or state insurer.
- The bill allows a state-licensed insurance producer to sell insurance on behalf of any insurer, including national insurers, operating within the state in which the producer holds a license.
- The bill authorizes the chartering of separate life and property-casualty insurers and authorizes the formation of holding companies that could own both life and property-casualty insurers.

NATIONAL INSURANCE ACT

- The bill directs the federal insurance commissioner to establish regulations barring unfair trade and claims practices.
- The bill creates an independent Office of National Insurance within the Treasury Department, whose commissioner would be appointed by the President for a 5-year term subject to Senate confirmation.
- Unlike the bill introduced in 2006, the 2007 bill drops health insurance from enumeration of permitted lines of business for national insurers.
- In addition, the bill exempts all federally chartered insurers/agencies and federally licensed producers from Federal Trade Commission oversight for antitrust and unfair trade practice violations.

NATIONAL INSURANCE ACT

- There is little consensus from the insurance industry on the issue of establishing a federal regulator.
- Efforts to create a federal regulator have been staunchly opposed by NAIC.
- Former NAIC President and Maine Superintendent of Insurance Alessandro Iuppa testified before the Senate Banking Committee last summer, stating that the bill would create “a bifurcated regulatory regime with redundant and overlapping responsibilities (that) will result in policyholder confusion, market uncertainty and other unintended consequences that will hurt individuals, families, and businesses that rely on insurance as protection against the risks of everyday life.”

NATIONAL INSURANCE ACT

- Groups such as the Independent Insurance Agents and Brokers of America (the Big “I”), the PIA and the National Association of Mutual Insurance Companies (NAMIC) and large insurers such as AFLAC, Inc., continue to oppose the proposal.

- However, some industry groups support the concept of an optional federal charter, including the American Insurance Association (AIA), American Bankers Insurance Association (ABIA), the American Bankers Association (ABA), Risk and Insurance Management Society (RIMS).

NATIONAL INSURANCE ACT

- Senator Sununu reportedly intends to push for at least one hearing and mark up of the bill this year.
- A hearing on the bill is not likely until September, when Senator Johnson, the bill's primary Democratic sponsor, is scheduled to return to the Senate after emergency surgery.
- In the Senate, neither the Banking Committee Chairman Christopher Dodd (D-Conn.), nor the ranking member, Richard Shelby, (R-Ala.) support passage of the bill this year.

NATIONAL INSURANCE ACT

- In addition, House Capital Markets Subcommittee Chairman Paul Kanjorski (D-PA) is expected to introduce a different federal charter bill later this year.

STATE INSURANCE AUTHORITY STUDY

- Earlier this year, NCOIL, in conjunction with the Insurance Legislators Foundation (ILF), launched a groundbreaking Study on State Insurance Authority.

- The study will take an in-depth, objective look at state insurance regulation in its current form in order to determine where it works well and where improvement may be necessary to better promote healthy, competitive insurance markets.

STATE INSURANCE AUTHORITY STUDY

- A stated purpose of the study is to develop a system which will allow for the modernization and improvement of the state regulated system which will address the concerns detailed in the SMART and Optional Federal Charter proposals, thus making such dual regulatory systems less appealing in light of their drawbacks and a viable state-run alternative.

- With the long history and demonstrated ability of the state-run system to evolve with changing insurance markets, NCOIL and ILF are confident that a state-run system remains the best way to regulate insurance.

STATE INSURANCE AUTHORITY STUDY

- The study, among other things, will be an analysis of the:
  - Laws, rules and procedures that enumerate the jurisdictional responsibilities of officials governing insurance and related consumer protections;
  - The nature and history of regulation over the business of insurance including issues regarding the authority that may be due non-profit corporations and similar entities;
  - Case studies that help explain the evolution leading to the current insurance regulatory environment, including the growth of assets and information utilization and security;
  - The extent and effectiveness of intra-governmental communication and cooperation regarding insurance law;

STATE INSURANCE AUTHORITY STUDY

- The impact that functional regulation, as established by the Gramm-Leach-Bliley Act of 1999, has had on insurance oversight and responsibility;
- The consequences of federal preemptive measures on insurance policymaking; and,
- The role that organizations such as NCOIL and other state legislative groups, such as the NAIC, National Governors Association (NGA) and National Association of Attorneys General (NAAG), play in insurance public policy.

STATE INSURANCE AUTHORITY STUDY

- The findings and recommendations will be used by NCOIL to set a strategic agenda for the development of a policy on state insurance regulation, which can be considered for adoption by each state.

NONADMITTED AND REINSURANCE REFORM ACT

- The Nonadmitted and Reinsurance Reform Act of 2006 was introduced in the House of Representatives by Congresswoman Ginny Brown-Waite (R-FL) on June 19, 2006.

- The stated purpose of the Bill was to streamline the regulation of non-admitted insurance and reinsurance.

- The bill provided specific instruction with regard to regulation of surplus lines insurers and reinsurers recognizing that there are several obstacles surplus lines insurers face dealing with interstate transactions.

NONADMITTED AND REINSURANCE REFORM ACT

- The bill was received favorably in the U.S. House.
- It passed the House Subcommittee on Capitol Markets, Insurance and Government Sponsored Enterprises on July 19, 2006, and the Financial Services Committee on July 26, 2006.
- It passed the full House of Representatives in late 2006 by a vote of 417-0.
- The bill was never considered in the Senate and, accordingly, was never passed.

NONADMITTED AND REINSURANCE REFORM ACT

- The Nonadmitted and Reinsurance Reform Act of 2007 (HR 1065) was introduced in the House Financial Services Committee on February 15, 2007, and boasts 41 sponsors.

- Primary sponsors of the legislation are Representatives Dennis Moore (D-KS) and Ginny Brown-Waite (R-FL).

- Similar to the bill introduced in 2006, the purpose of the 2007 bill is to streamline the regulation of non-admitted insurance and reinsurance.

NONADMITTED AND REINSURANCE REFORM ACT

- The bill focuses on reforming the taxation and regulation of multi-state surplus lines procurements.

- The bill would establish national standards for state regulation of the surplus lines and reinsurance markets, including a uniform system of surplus lines premium taxation, elimination of duplicative compliance requirements for multi-state surplus lines transactions and provide direct access to the surplus lines market for large commercial insurance buyers.

NONADMITTED AND REINSURANCE REFORM ACT

- Specifically, the bill:
  - Prohibits any state other than the home state of an insured from requiring a premium tax payment for non-admitted insurance.
  - Authorizes states to enter into procedures to allocate among themselves the premium taxes paid to an insured's home state.

NONADMITTED AND REINSURANCE REFORM ACT

- Allows an insured's home state to require surplus lines brokers and certain insureds to file annually tax allocation reports detailing the portion of the non-admitted insurance premiums attributable to properties, risks, or exposures located in each state.

- Declares that Congress intends that each state adopt a uniform procedure that provides for the reporting, payment, collection and allocation of premium taxes for non-admitted insurance.

- Subjects non-admitted insurance solely to the regulatory requirements of the insured's home state.

NONADMITTED AND REINSURANCE REFORM ACT

- Declares that only an insured's home state may require a surplus lines broker to be licensed to conduct non-admitted insurance business with respect to such insured.

- Prohibits a state from collecting fees relating to licensure of a surplus lines broker unless it has a regulatory mechanism for participation in the national insurance producer database of the NAIC, or any other equivalent uniform national database.

NONADMITTED AND REINSURANCE REFORM ACT

- Prohibits a state from:
  - Establishing eligibility criteria for non-admitted insurers domiciled in a U.S. jurisdiction except in conformance with the Non-Admitted Insurance Model Act; or,
  - Barring a surplus lines broker from placing non-admitted insurance with, or procuring non-admitted insurance from, a non-admitted insurer domiciled outside the United States and listed on the NAIC International Insurers Department Quarterly Listing of Alien Insurers.

NONADMITTED AND REINSURANCE REFORM ACT

- Prohibits a state from denying credit for reinsurance if the state of domicile of an insurer purchasing reinsurance recognizes credit for reinsurance for the insurer's ceded risk and:
  - Is either an NAIC- accredited state; or,
  - Has financial solvency requirements substantially similar to NAIC accreditation requirements.

NONADMITTED AND REINSURANCE REFORM ACT

- Reserves to the state of domicile of a reinsurer sole responsibility for regulating the reinsurer's financial solvency if the state is NAIC- accredited, or has financial solvency requirements substantially similar to NAIC accreditation requirements.

- Prohibits a state from requiring a reinsurer to provide financial information other than that required to be filed with the reinsurer’s NAIC- compliant domiciliary state.

NONADMITTED AND REINSURANCE REFORM ACT

- As expected, the bill moved directly to the House floor under expedited procedures, in order to beat the10-day Congressional recess, which began June 29 and ends on July 10 for the House.

- HR 1065 unanimously passed the House of Representatives on June 25, 2007, after an abbreviated floor debate.

NONADMITTED AND REINSURANCE REFORM ACT

- The Senate companion bill (S. 929) was introduced in the Senate in February by Florida's Senators Bill Nelson (D-FL) and Mel Martinez (R-FL).
- On March 20, 2007, the bill was referred to the Senate Committee on Banking, Housing and Urban Affairs.
- The Senate bill is likely to be amended to include language that is specific as to who qualifies as an "exempt commercial purchaser".
- However, a timetable for Senate action is unclear.

NONADMITTED AND REINSURANCE REFORM ACT

- The bills have been lauded by the PCI, Council of Insurance Agents and Brokers (CIAB), American Association of Managing General Agents (AAMGA), the AIA, NAPSLO and The Big “I”.

- There has been some opposition by surplus lines brokers regarding the requirement that the placement of non-admitted insurance be subject to the statutory and regulatory requirements of the insured's home state.

SURPLUS LINES COMPACT

- A group within the NAIC is considering creating an interstate compact to provide uniform regulation of excess and surplus lines transactions.
- The group, consisting of insurance company representatives and state regulators, has been meeting for more than a year.
- Similar to the Nonadmitted and Reinsurance Reform Act of 2007, the proposed compact establishes national standards for state regulation of the surplus lines and reinsurance markets, including a uniform system of surplus lines premium taxation.

SURPLUS LINES COMPACT

- The proposed compact focuses on the key states of New York, California, Texas and Florida, that account for over 50 percent of the surplus lines business in the U.S.

- The current draft of the proposed interstate compact would require each state to collect risk allocation information from the broker, and a compact-created clearinghouse would calculate how much money is owed to each state based on a uniform allocation formula, which would be reported to states and brokers.

SURPLUS LINES COMPACT

- This proposal differs from the Nonadmitted and Reinsurance Reform Act of 2007, which requires taxes be paid to the home state, and the home state would then be responsible for redistribution.
- Additionally, the proposal would require states to participate in the NAIC or other national producer databases in order to collect licensing fees, while the Nonadmitted and Reinsurance Reform Act of 2007 does not.
- A final draft of the proposed interstate compact is expected to be ready by the NAIC's September quarterly meeting.
- If adopted by regulators, the next step would be for each state legislature to consider and possibly enact the compact into law.

REINSURANCE REGULATORY FRAMEWORK

- There has been increased pressure for reform of the U.S. regulatory system regarding credit for reinsurance.
- Under the U.S. Credit for Reinsurance rules, regulators require alien reinsurers to place collateral equal to 100% of their gross actuarially estimated U.S. liabilities into a U.S. based trust fund.
- Often, alien reinsurers are required to set aside billions of dollars in collateral to support their U.S. underwriting, which ties up capital, creates significant costs for doing business in the U.S. and ultimately puts them at a disadvantage against U.S. competitors.

REINSURANCE REGULATORY FRAMEWORK

- In some cases, alien insurers and reinsurers operate through U.S. subsidiaries in order to avoid these requirements.
- Lloyd's structure precludes it from setting up U.S. subsidiaries.
- As a result, Lloyd’s alone places over $11 billion into trust funds in order to underwrite business in the U.S.
- Meanwhile, U.S. domestic companies that meet certain required standards are not required to maintain reserves in separate trust funds, even if the companies have lower financial security ratings.

REINSURANCE REGULATORY FRAMEWORK

- The U.S. is the only major insurance market in the world that imposes such collateral rules.

- It is estimated that the annual costs of complying with the U.S. collateral requirements runs in excess of $500 million per year for international reinsurers, and for Lloyd's alone, the cost is nearly $150 million.

REINSURANCE REGULATORY FRAMEWORK

- During 2005, the NAIC Reinsurance Task Force published a White Paper that examined the prudential and supervisory issues related to credit for reinsurance.
- As a result, regulators instructed the Task Force to consider alternatives to the current regulatory framework for credit for reinsurance at the Spring 2006 NAIC meeting.
- The Task Force was asked to develop methods of assessing the financial strength of reinsurers, regardless of their country of domicile, as well as confer with international regulators, including the Financial Services Authority, Lloyd's and other international reinsurers on the issue.

REINSURANCE REGULATORY FRAMEWORK

- During the Summer 2006 NAIC meeting, regulators voted unanimously to explore an alternative to full collateralization for alien reinsurers.
- Specifically, regulators proposed a ratings-based system that would replace the collateral requirements and asked for comments from interested parties.
- The ratings-based model would amend the credit for reinsurance laws to establish a regulatory system that distinguishes financially strong reinsurers from weak reinsurers, without relying exclusively on their state or country of domicile, with collateral to be determined as appropriate.

REINSURANCE REGULATORY FRAMEWORK

- The intent of the proposal is to develop enhanced regulatory requirements that provide reasonable and prudent controls over the reinsurance credit risk exposure of U.S. ceding insurers.
- These requirements would apply to all reinsurers, regardless of whether they are licensed, accredited or unauthorized.
- Under the proposal, the Reinsurance Evaluation Office (REO) would be created to examine and rate the financial strength of all reinsurers transacting business in the U.S.

REINSURANCE REGULATORY FRAMEWORK

- Under the proposal, reinsurers wishing to be rated would undergo a detailed application process.

- Upon reviewing the applications, the REO would assign an appropriate rating to each reinsurer based on various credit criteria, including:
  - The financial strength ratings issued to the reinsurer by nationally recognized statistical rating organizations such as A.M. Best, Standard & Poors, Moody's, and Fitch Ratings;
  - The strength of financial solvency regulation in the reinsurer's home jurisdiction;
  - The length of time a reinsurer has been in business; and,
  - The reinsurer's reputation for prompt payment of valid claims.

REINSURANCE REGULATORY FRAMEWORK

- The reinsurer’s rating places it into one of six categories, and the reinsurer's collateral obligation would correspond to its rating.
- A reinsurer receiving an REO-1 rating would not be required to post any collateral, whereas a reinsurer receiving an REO-6 rating would be required to secure its reinsurance obligations at 100% or higher.
- Under this model, Lloyd’s would be rated REO-3 and its collateral would be reduced to 40% from the current 100%.

REINSURANCE REGULATORY FRAMEWORK

- During the Winter 2006 NAIC meeting, the Task Force heavily debated the ratings-based proposal and ultimately passed the proposal by a 15-5 vote.
- In the Spring of 2007, the Task Force was issued two new Charges.
- The first Charge instructs the Task Force to develop a risk-based evaluation process for purposes of collateral recalibration as part of implementation of the ratings-based proposal.

REINSURANCE REGULATORY FRAMEWORK

- The second Charge requests the Task Force to consider the design of a revised U.S. reinsurance regulatory framework.
- A full status report of the first Charge was due at the Summer 2007 meeting, working towards a September completion, and a full status report on the second Charge is not expected before the end of the year.
- The Task Force struggled with the dual charges, and the drafting committee continues to work on both issues, although some regulators would prefer to focus their resources on reform.
- During the summer, the Task Force will hold interim meetings and conference calls to debate and develop the ratings-based proposal.

REINSURANCE REGULATORY FRAMEWORK

- The debate over credit for reinsurance continues as many new insurance commissioners are becoming involved.
- Alabama Commissioner Walter Bell took over as NAIC President from Maine Commissioner Al Iuppa, who has been a strong supporter of reinsurance reforms in the past.
- In addition, Georgia Commissioner John Oxendine chairs the Task Force and plays an important role in the issue.

REINSURANCE REGULATORY FRAMEWORK

- The insurance industry has mixed feelings regarding the ratings-based proposal.

- Proponents argue that:
  - The new rules would eliminate unnecessary costs and disincentives for non-domestic reinsurers to write U.S. business; and,
  - The new rules are necessary to ensure that U.S. credit for reinsurance requirements are consistent with developments in the international reinsurance industries.

- Most non-U.S. reinsurers are in favor of the proposed ratings approach, as they believe it levels the playing field with their U.S. competitors.

REINSURANCE REGULATORY FRAMEWORK

- However, many U.S. based insurers and reinsurers are opposed to the proposal.
- They claim the new rules would undermine the financial security of U.S. ceding companies and diminish the incentive of non-U.S. reinsurers to become licensed in the U.S.
- Others believe that U.S. reinsurers would be at a disadvantage because they would be required to comply with the collateral obligations and U.S. licensing requirements simultaneously.
- Opponents favor maintaining the current collateral requirements or developing other alternatives.

REINSURANCE REGULATORY FRAMEWORK

- Recently, NCOIL approved an amendment to its Credit for Reinsurance Model Regulation that establishes a framework for an approved list of reinsurers.
- The specific criteria for the list would be established by U.S. regulators.
- NCOIL's Executive Committee has held two debates on whether to approve the proposed reform and has sent its findings to the state legislators for consideration.

REINSURANCE REGULATORY FRAMEWORK

Florida 2007 Special Session

- A Special Session of the Florida Legislature was convened in January 2007 to exclusively address property insurance issues in Florida, which produced House Bill 1A (HB 1A), which amended Section 624.462, *Fla. Stat.*

- The new legislation authorizes the Florida Office of Insurance Regulation to waive or lower the deposit requirement for all reinsurers, domestic, foreign and alien, based on criteria related to the financial strength of the reinsurer and the quality of the regulatory jurisdiction.

- In addition, HB 1A requires that the assuming reinsurer have at least $100 million in surplus in order to qualify for this waiver or reduction in required deposit.

TERRORISM RISK INSURANCE ACT

- The Terrorism Risk Insurance Act (TRIA) was adopted in November 2002, to stimulate business investment and stabilize the insurance market after the events of September 11, 2001.
- The act created a three-year federal program to provide partial compensation for losses resulting from certain terrorist-related events committed on behalf of a foreign person or foreign interest.
- The act was intended as a short-term solution for the unavailability of terrorism coverage for U.S. risks.
- TRIA provided a shared compensation mechanism for defined terrorism claims to be allocated between the insurance industry and the U.S. Federal Government.

TERRORISM RISK INSURANCE ACT

- U.K., France, Spain and Germany have some form of a national public terrorism risk insurance program that works with the private sector and provides coverage similar to TRIA.

- France and Spain also have national programs addressing a wide range of natural catastrophe risks.

TERRORISM RISK INSURANCE ACT

- TRIA did not apply to acts perpetuated by domestic terrorists.
- TRIA applied to specified primary and excess commercial property and casualty coverage(s), including workers' compensation and surety.
- Also, TRIA applied for aggregate insurance industry loses exceeding $5 million.
- TRIA provided for individual company deductibles for each year.

TERRORISM RISK INSURANCE ACT

- The annual deductible for each insurer was based upon direct earned premium of the insurer for the preceding calendar year in the following percentage amounts: 2002: 1%; 2003: 7%; 2004: 10%; and, 2005: 15%.

- In addition to individual company deductibles, TRIA provided for industry deductibles, as follows: 2003: $10 Billion; 2004: $12.5 Billion; and, 2005: $15 Billion.

- TRIA provided for an overall maximum cap of $100 billion for terrorism related losses.

TERRORISM RISK INSURANCE ACT

- TRIA required insurers, including surplus lines, to make terrorism coverage available to specified commercial insureds.
- TRIA voided any previously existing terrorism exclusions, unless the insured rejected the offer of coverage, or refused to pay any additional premium for such coverage.
- TRIA required insurers to include disclosure notices that informed the insured of the existence of the TRIA and identify any premium charge for TRIA coverage.
- TRIA was set to terminate on December 31, 2005.

TERRORISM RISK INSURANCE EXTENSION ACT

- On December 22, 2005, President Bush signed into law the Terrorism Risk Insurance Extension Act (TRIEA) of 2005, which extends TRIA until December 31, 2007.
- The act creates a new “program trigger” for any certified act of terrorism occurring after March 31, 2006.
- The new trigger prohibits payment of Federal compensation by the United States Treasury unless the aggregate industry-insured losses resulting from the act of terrorism exceeds $50 million for 2006 and $100 million for 2007.
- The Act adjusts the insurer deductibles in 2006 to 17.5% and to 20% in 2007.

TERRORISM RISK INSURANCE EXTENSION ACT

- The main goals of TRIEA:
  - Continue availability and affordability of insurance from certified acts of terrorism;
  - Preserve state insurance regulations;
  - Provide a transitional period for private markets to stabilize and build capacity; and,
  - Provide for equitable distributions of shared costs of recovery.

TERRORISM RISK INSURANCE EXTENSION ACT

- The Act changes the federal share of compensation for insured losses in 2007 from ninety percent (90%) to eighty-five percent (85%) of the amount of such insured losses that exceeds the applicable insurer retention.

- The Act provides for a revised definition of “property and casualty insurance” that now excludes the following types of insurance:
  - Commercial automobile insurance;
  - Burglary and theft insurance;
  - Surety insurance;
  - Professional liability insurance, and,
  - Farm owners multi-peril insurance.

TERRORISM RISK INSURANCE EXTENSION ACT

	TRIA	TRIEA
Deductible	15%	17.5% 2006 20% 2007
Expiration	12/31/05	12/31/07
Payment Trigger	Greater than $5M	Greater than $50M -04/01/06 Greater than $100M - 1/01/07
Federal Share	90%	90% 2006 85% 2007
Lines Covered	All Commercial P&C Workers compensation	Also excludes: Commercial Auto Burglary and Theft Surety Farm Owners Multiperil Professional Liability

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TERRORISM RISK INSURANCE EXTENSION ACT

- The renewal of terrorism coverage is the top legislative priority for the property-casualty insurance industry.
- As the expiration of TRIEA approaches, conservative Republicans and the White House both oppose an extension of the federal program out of concern it will create another unfunded federal liability.
- However, some House Democrats (mainly members from New York) argue that the program should be extended for 10 years or more.

TERRORISM RISK INSURANCE EXTENSION ACT

- Earlier this year, Congress took the first step toward renewing governmental support for terrorism insurance through its annual budget resolution process, which allowed for an extension of TRIA for up to five years.

- The resolution language gave the go-ahead for “various committees to act to ensure a continuing federal role in the continued availability of terrorism insurance”, so long as it does not add to the budget deficit.

- It also provided for expedited handling of legislation that would renew TRIA.

TERRORISM RISK INSURANCE REVISION AND EXTENSION ACT

- The Terrorism Risk Insurance Revision and Extension Act of 2007 (TRIREA), was introduced in the House on June 18, 2007, and would revise and extend TRIA for another ten years. The proposed extension was subsequently increased to fifteen years.

- The legislation was introduced by Representative Mike Capuano (D-MA), a member of the House Financial Services Committee, and the Committee Chairman, Representative Barney Frank (D-MA).

TERRORISM RISK INSURANCE REVISION AND EXTENSION ACT

Key Components/Revisions of the Act

- Extends TRIA for 15 years with current co-payments and deductibles for conventional terrorism acts;
- Expands the “make available” requirement for carriers to include NBCR attacks;
- Changes TRIA’s definition of terrorism to include acts of domestic terrorism;
- Sets the program trigger at $50 million;

TERRORISM RISK INSURANCE REVISION AND EXTENSION ACT

- Adds group life insurance to the lines of insurance for which terrorism coverage must be made available;
- Decreases deductibles and triggers for areas previously impacted by a significant terrorist attack;
- Maintains post-event mandatory repayment amounts for property-casualty losses at $27.5 billion. This relates to the total amount property-casualty insurers are required to collect through surcharges for recoupment to the federal government following a certified act of terrorism; and,
- Continues to require studies on the development of a private market for terrorism risk insurance.

TERRORISM RISK INSURANCE REVISION AND EXTENSION ACT

- A hearing was held on the bill on June 21, 2007, before the Subcommittee on Capital Markets, Insurance and Governmental Sponsored Enterprises.
- One central and contentious issue surrounding the renewal of TRIA involves the addition of nuclear, biological, chemical and radiological (NBCR) attacks to the conventional terrorism risks covered under the current federal backstop.
- Groups of large commercial policyholders, including real estate investment firms, national banks and manufacturers, have been lobbying to add NBCR attacks to the program.
- The insurance industry has been split on the issue, setting large and small insurers against one another.

TERRORISM RISK INSURANCE REVISION AND EXTENSION ACT

- The AIA and the Coalition to Insure Against Terrorism (CIAT) have proposed a requirement that all property insurers offer insurance for NBCR attacks, with the federal government stepping in to cover losses above a specified amount.

- Smaller insurers contend that private insurers should not be required to offer coverage for terrorism attacks as a result of NBCR, and many say underwriting such coverage is beyond their expertise and capacity.

- The AIA and CIAT have proposed a compromise, whereby the retention rate for industry coverage would remain at the current twenty percent (20%) if the government were to specifically include NBCR.

TERRORISM RISK INSURANCE REVISION AND EXTENSION ACT

- Certain insurers, mostly represented by PCI and NAMIC, do not support this proposal because mandating NBCR coverage would cause many insurer insolvencies in the event of an attack.
- Any legislation including federal coverage for NBCR risks that passes the House will need to survive the Senate, which appears disinclined to include coverage for NBCR risks.
- Meanwhile, the White House, which has tended to believe in free market solutions as opposed to government initiatives, still views the backstop as a temporary measure and was reluctant to extend TRIA for only two additional years in 2005.
- However, the President has not threatened to veto this legislation as of this date.

TERRORISM RISK INSURANCE REVISION AND EXTENSION ACT

- On August 1, 2007 the House Financial Services Committee passed an amended version of the legislation by a vote of 49 to 20. Most significantly, the amended legislation provides for the extension of TRIA for fifteen (15) years rather than the ten (10) years originally proposed.

- The House Committee's passage of the bill in received immediate approval from the AIA, and slightly less enthusiastic approval from NAMIC.

- The 5 year extension has increased opposition from the White House.

FEDERAL CATASTROPHE FUND

- The creation of a Federal Catastrophe Fund is once again an active topic of debate and discussion across the United States.

- On March 27, 2007, the Financial Services Committee of the U.S. House of Representatives held a hearing to discuss the possibility of creating a Federal Cat Fund.

- Representative Ginny Brown-Waite (R-FL) used her testimony to promote two bills she had proposed, pertaining to the establishment of a Federal Cat Fund: the Homeowners Insurance Protection Act (HR 91) and the Homeowners Insurance Availability Act (HR 330).

FEDERAL CATASTROPHE FUND

- Support for the creation of a Federal Cat Fund is dominated by representatives from the Gulf Coast states, especially Florida.
- In general, supporters argue that the federal government is already spending billions of dollars on assistance after major disasters, so citizens nationwide are theoretically already paying for catastrophes.
- Florida Governor Charlie Crist also strongly supported the creation of a Federal Cat Fund.
- The Chairman of the House Financial Services Committee, Representative Barney Frank (D-MA), has asked Democratic Florida Representatives Ron Klein and Tim Mahoney, both members of the Financial Services Committee, to form a task force to investigate the creation of a Federal Cat Fund.

FEDERAL CATASTROPHE FUND

- The most prominent opposition to the establishment of a Federal Cat Fund comes from the Bush Administration.
- Edward Lazear, Chairman of the White House Council of Economic Advisers, testified before the House Financial Services Committee, stating that he believes a Federal Cat Fund would displace the private market and have unintended economic consequences.
- In addition, a Federal Cat Fund is unlikely to garner widespread public support, since it essentially requires the entire country to subsidize the catastrophic losses of a few states.
- The response of industry organizations is mixed.

FEDERAL CATASTROPHE FUND

Homeowners Insurance Protection Act (HR 91)

- The Homeowners Insurance Protection Act was introduced by Representatives Brown-Waite (R-FL) and Vern Buchanan (R-FL) on January 4, 2007.

- Co-sponsors of the bill are Rep. Gus Bilirakis (R-FL), Rep. Lincoln Diaz-Balart (R-FL), Rep. Mario Diaz-Balart (R-FL), Rep. Tom Feeney (R-FL), Rep. Jim Gerlach (R-PA), Rep. Bart Gordon (D-TN), Rep. Walter Jones, Jr. (R-NC), Rep. Ric Keller (R-FL), Rep. Jeff Miller (R-FL), Rep. Ileana Ros-Lehtinen (R-FL) and Rep. C.W. Young (R-FL).

- The bill establishes a program to provide reinsurance for State natural catastrophe insurance programs to help the US better prepare for and protect its citizens against natural catastrophes,

FEDERAL CATASTROPHE FUND

to encourage and promote mitigation and prevention for, and recovery and rebuilding from, such catastrophes, and to better assist in the financial recovery from such catastrophes.

- The bill would allow states that have established state Cat Funds to purchase reinsurance contracts from the federal government.
- In order to be eligible to participate in the program, the laws establishing the state Cat Fund would include prevention and mitigation provisions.
- Under the bill, the program is expressly prohibited from competing with private insurance, reinsurance or capital markets.

FEDERAL CATASTROPHE FUND

- The contracts offered would be for a one year term.
- Pricing would be based on certain factors including risk-based price, risk load and administrative costs.
- The lines of business covered would include residential property (including condominiums and cooperatives) and the contents of apartment buildings.
- Covered perils would include earthquakes and earthquake-related perils (e.g., fire and tsunamis); tropical cyclones, hurricanes and typhoons; tornadoes; volcanic eruptions; catastrophic winter storms; and other natural catastrophes.
- The peril of flood is not included.

FEDERAL CATASTROPHE FUND

- The Cat Fund could not be used unless a 1:200 year, or more severe, event occurs.
- Once the Cat Fund is triggered, the federal government would be responsible for 90 percent of the amount of insured losses of the eligible state Cat Funds in excess of the amount of retained losses.
- The states would be required to pay the remaining 10 percent.

FEDERAL CATASTROPHE FUND

- The private sector would compete for the opportunity to offer reinsurance coverage that is substantially similar to coverage otherwise made available under the program.
- These private entities would be required to have at all times capital sufficient to satisfy the terms of the reinsurance contracts.
- Entities desiring to participate would submit written expressions of interest in providing reinsurance coverage in lieu of the coverage otherwise made available under this law, and the Catastrophe Preparation Commission would select which applicants it deems qualified to participate.

FEDERAL CATASTROPHE FUND

- The bill would also establish a pass through mechanism that would require any cost savings for providing insurance coverage for risks in a state to be reflected in premium rates charged to consumers for such coverage.

- The bill would allow any insurer who participates in an eligible state Cat Fund to establish a Catastrophe Capital Reserve Fund, which could not be used unless a 1:100 year event occurred.

- The last action on the bill was a referral to the House Financial Services Committee in January, 2007.

FEDERAL CATASTROPHE FUND

Homeowners Insurance Availability Act (HR 330)

- The Homeowners Insurance Availability Act was introduced by Representative Brown-Waite and co-sponsored by Representative Gus Bilirakis (R-FL) on January 9, 2007.

- The bill establishes a Federal program to provide reinsurance to improve the availability of homeowners' insurance.

FEDERAL CATASTROPHE FUND

- The bill would create a program that would auction contracts for reinsurance coverage.
- Contracts would be made available to private insurers and reinsurers, state insurance and reinsurance programs and other interested entities.
- The program would be executed on a regional basis in at least six areas, including separate regions for all or part of California and all or part of Florida.
- This bill requires each purchaser of a contract to establish mitigation programs, not to exceed five percent of the price paid for the contract, in certain communities.

FEDERAL CATASTROPHE FUND

- The Fund created by the bill would only be available if a 1:100 year, or more severe, event occurs.
- The contracts offered would not pay more than 50 percent of eligible losses in excess of retained losses for the region for which the contract was purchased.
- The lines of business covered would include residential property (including condominiums and cooperatives) and the contents of apartment buildings.
- Covered perils would include earthquakes and earthquake-related perils (e.g., fire and tsunamis); and tropical cyclones, including hurricanes and typhoons.

FEDERAL CATASTROPHE FUND

- The bill would divide the nation into six different regions in which the federal government could auction off reinsurance contracts to private insurers and reinsurers, state insurance and reinsurance programs, and “other interested entities.”

- As a condition of the contract, purchasers would be required to contribute an amount not greater than five percent of the price paid for the contract to certain states as determined by the Secretary of the Treasury.

FEDERAL CATASTROPHE FUND

- The bill would establish the National Commission on Catastrophe Risks and Insurance Loss Costs, whose sole purpose would be to make recommendations regarding the estimated loss costs associated with the contracts for reinsurance coverage under the bill.

- The bill would create within the Treasury Department a fund to be known as the Disaster Reinsurance Fund which would be used to pay covered purchasers under reinsurance coverage contracts, among other things.

- The last action on the bill was a referral to the House Financial Services Committee in January, 2007.

FEDERAL CATASTROPHE FUND

- In addition, Congress is considering several bills to attempt to address issues related to the industry's ability to handle catastrophic events.

- Specifically, two bills that are currently in consideration are the Commission on Catastrophic Disaster Risk Insurance Act of 2007 (S.292) and the Policyholder Disaster Protection Act of 2007 (HR 164).

FEDERAL CATASTROPHE FUND

The Commission on Catastrophic Disaster Risk Insurance Act of 2007 (S.292)

- The Commission on Catastrophic Disaster Risk Insurance Act of 2007 establishes a Commission on Catastrophic Disaster Risk and Insurance to assess the condition of the property and casualty insurance and reinsurance markets in the aftermath of 2004 and 2005 Hurricanes, and the ongoing exposure of the United States to earthquakes, volcanic eruptions, tsunamis and floods.

- This bill also recommends legislative and regulatory changes that will improve the financial health and competitiveness of such markets.

FEDERAL CATASTROPHE FUND

- The bill requires the Commission to submit its final report to the President and Congress in 90 days.
- The bill terminates the Commission sixty (60) days after the submission of its final report.
- The bill is currently under consideration in the Senate Committee on Commerce, Science and Transportation.
- The bill was reported out to the Senate Banking Committee and was completely rewritten and renamed The Commission on Natural Catastrophe Risk Management and Insurance Act of 2007.

FEDERAL CATASTROPHE FUND

- Under the rewritten bill, the Commission must now prepare a report to Congress by December 1, 2008.

- The legislation now includes two key issues:

  (a). the impact of stronger building codes;

  (b). the effect rate regulation has on catastrophe insurance.

- This new legislation is supported by the AIA, NAMIC, PCI, and the Big "I".

FEDERAL CATASTROPHE FUND

Policyholder Disaster Protection Act of 2007 (HR 164)

- The Policyholder Disaster Protection Act of 2007 amends the Internal Revenue Code of 1986 to provide for the creation of disaster protection funds by property and casualty insurance companies for the payment of policyholders' claims arising from future catastrophic events.
- The bill permits accumulation of pretax dollars in separate reserve funds devoted solely to the payment of claims arising from major natural disasters and would apply to taxable years beginning after December 31, 2007.
- The bill was referred to the House Committee on Ways and Means.

FEDERAL CATASTROPHE FUND

Homeowners' Defense Act of 2007

- Introduced in the House in August 2007.
- The purposes of this Act are to establish a program to provide a Federal backstop for State-sponsored insurance programs to help homeowners prepare for and recover from the damages caused by natural catastrophes, to encourage mitigation and prevention for such catastrophes, to promote the use of private market capital as a means to insure against such catastrophes, to expedite the payment of claims and better assist in the financial recovery from such catastrophes.
- Although likely to pass in the House, the bill has opposition from the White House and several insurance associations.

NATIONAL FLOOD INSURANCE PROGRAM

- Under the National Flood Insurance Program (NFIP), which is administered by the Federal Emergency Management Agency (FEMA), flood insurance is made available to homeowners, renters and business owners that is not otherwise available in the private marketplace.

- The NFIP is a pre-disaster flood mitigation and insurance protection program designed to reduce the cost of disasters.

- It was created in 1968 in response to the rising cost of taxpayer-funded disaster relief for flood victims and the increasing amount of property damage caused by floods.

NATIONAL FLOOD INSURANCE PROGRAM

- On March 23, 2006, President Bush signed into law a bill that increased the borrowing authority for the NFIP to $20.8 billion, from $18.5 billion.
- On June 27, 2006, the House passed H.R. 4973, the Flood Insurance Reform and Modernization Act of 2006.
- The bill increased FEMA's borrowing authority to $25 billion to cover claims arising from the catastrophic hurricanes in 2005 and sought to reform perceived weaknesses in the program.

NATIONAL FLOOD INSURANCE PROGRAM

- On May 25, 2006, the Senate Banking Committee passed legislation that would overhaul the NFIP and would make the program self-sustaining and less reliant on taxpayer money to fund shortages.

- The House and Senate could not come to an agreement on their respective bills in 2006.

NATIONAL FLOOD INSURANCE PROGRAM

- On March 26, 2007, Representatives Barney Frank (D-MA) and Judy Biggert (R-IL) introduced the Flood Insurance Reform and Modernization Act of 2007, H.R. 1682.
- The bill currently has 14 co-sponsors.
- It attempts to address a number of weaknesses in the National Flood Insurance Program that were exposed by the unprecedented 2005 hurricane season.

NATIONAL FLOOD INSURANCE PROGRAM

- More specifically, the bill:
  - Attempts to make the NFIP more actuarially sound by phasing out subsidized rates on vacation homes and second homes.
  - Makes small business owners eligible to purchase business interruption coverage in order to meet payroll and other obligations in the event of flooding.
  - Updates maximum insurance coverage limits for residential and nonresidential properties.

NATIONAL FLOOD INSURANCE PROGRAM

- Increases the NFIP borrowing authority to ensure that all outstanding claims and Federal obligations are paid.
- Increases the amount by which FEMA can raise policy rates in any given year from 10% to 15%.
- Increases the fines on lenders who do not enforce the mandatory flood insurance policy purchase requirement for those who live in a floodplain and hold a federally-backed mortgage.
- This provision attempts to ensure that those homeowners who should have flood insurance actually purchase it.

NATIONAL FLOOD INSURANCE PROGRAM

- The last major action on the bill occurred on Tuesday, June 12, 2007, during a meeting of the Subcommittee on Housing and Community Opportunity.

- At the meeting, several industry groups testified in favor of the legislation including Mark Davey, the President and Chief Executive Officer of Fidelity National Insurance Company on behalf of his company and the PCI, as well as the Independent Insurance Agents and Brokers of America.

- Mr. Davey offered his support for many of the provisions in the bill that will provide for greater participation in the NFIP.

NATIONAL FLOOD INSURANCE PROGRAM

- Mr. Davey also outlined several important issues that are not addressed in the bill, but should be:
  - Providing relief from debts incurred by the NFIP as a result of Hurricane Katrina;
  - Reauthorizing the program on a long-term basis (i.e.: 10 years); affirming federal court jurisdiction over policy and claims disputes under the NFIP;
  - Enhancing mitigation standards;
  - Expanding mandatory purchase requirements to properties that have sustained a flood loss, are located behind a levee or near major bodies of water;

NATIONAL FLOOD INSURANCE PROGRAM

- Revising the Standard Flood Insurance Policy to make it more consistent with standard homeowners and other insurance products; and,
- Ensuring that FEMA pays those with flood insurance ahead of those without.

- Other insurance groups are also supporting this legislation.

NATIONAL FLOOD INSURANCE PROGRAM

The Multiple Peril Insurance Act of 2007

- The Multiple Peril Insurance Act of 2007 (H.R. 920) amends the National Flood Insurance Act of 1968 to require the national flood insurance program to enable the purchase of optional insurance against loss resulting from physical damage to or loss of real or related personal property located in the US arising from any flood or windstorm (hurricane, tornado, cyclone, typhoon, or other wind event).
- The bill prohibits duplication of coverage: cannot have both multi-peril insurance and flood insurance for the same structure.
- The bill prescribes the nature and terms of coverage, and actuarial rates.

NATIONAL FLOOD INSURANCE PROGRAM

- The bill requires communities to adopt adequate land use and control measures in order for multi-peril coverage to be available.
- The bill prohibits multi-peril coverage for structures in violation of state or local ordinances.
- The bill provides for available coverage for residential structures up to $500,000.
- The bill provides for available coverage for residential contents and necessary increases in living expenses up to $150,000.

NATIONAL FLOOD INSURANCE PROGRAM

- The bill provides for available coverage for nonresidential structures up to $1 million.
- The bill provides for available coverage for nonresidential contents and business interruption up to $750,000.
- The bill was referred to the House Committee on Financial Services on February, 8, 2007.
- H.R. 920 passed the House Committee in July, 2007. Congressman Taylor, the bill's sponsor, predicts it will pass when it comes to the House floor in September.

WIND INSURANCE VS. FLOOD INSURANCE

- There is an ongoing debate and litigation regarding whether standard homeowners or dwelling policies, which exclude flood coverage, cover certain damage caused by wind-driven water or flood as a result of Hurricane Katrina.

- Three states have been at the forefront in these debates: Florida, Louisiana and Mississippi.

WIND INSURANCE VS. FLOOD INSURANCE

- In the first rulings by a court in Louisiana on damage from Hurricane Katrina, Judge Stanwood Duval Jr. of the U.S. District Court in New Orleans held that insurance companies should pay for the widespread water damage.

- On August 2, 2007 however, Judge Duval's decisions were overturned by a federal appeals court in four consolidated cases in *In re Katrina Canal Breaches Litigation* before the U.S. Court of Appeals for the Fifth Circuit.

- A federal judge in Mississippi supported the industry's contention that most property insurance policies did not provide coverage for flooding.

WIND INSURANCE VS. FLOOD INSURANCE

- The appellate decisions to date are in the federal courts. The issue will be argued before the Louisiana state courts before the Court of Appeals on September 12, 2007.

- Florida courts addressed the issue in 2004 and, as a result of Hurricane Katrina, the Louisiana and Mississippi courts are currently handling a massive influx of litigation regarding claims for water damaged and/or flooded homes.

WIND INSURANCE VS. FLOOD INSURANCE

- Although the details of each case may differ, the basic facts are usually as follows:
  - Most homeowners and dwelling insurance policies expressly exclude coverage for flood damage.
  - The policies also typically contain anti-concurrent clauses which prohibit recovery for damage from non-covered perils that occur at the same time as damage from covered perils.

WIND INSURANCE VS. FLOOD INSURANCE

- The U.S. Government has created the National Flood Insurance Program to provide insurance coverage for flood damage.

- However, many insureds have not obtained this flood coverage and have stated that they were either unaware of the program or thought their homeowner's policy covered all hurricane-related damage.

WIND INSURANCE VS. FLOOD INSURANCE

- As a result, many insureds either had minimal or no flood insurance coverage. Insureds have filed claims against their homeowners' insurance companies seeking recovery for flood damage as a result of recent hurricane activity arguing that:
  - The exclusions in the anti-concurrent clauses contained in the insurance policies are unconscionable; and,
  - A combination of wind and water damage caused a total loss of the property and all damages should therefore be covered.
- In many cases, the homes are so severely damaged it is difficult, if not impossible, to differentiate flood damage from wind damage.

WIND INSURANCE VS. FLOOD INSURANCE

- In 2004, Florida's Fourth District Court of Appeals issued a ruling regarding a wind and flood dispute in *Mierzwa v. Florida Windstorm Underwriting Association.*

- The court ruled that insureds may recover policy limits from their homeowners' carriers in combination wind/flood damage cases when damage from a covered peril combined with damage from a non-covered peril causes the home to be a "total loss" as defined by local ordinances.

- The court based its ruling on Florida's "Valued Policy Law," which provided that in cases of a total loss, the insurer must pay policy limits.

WIND INSURANCE VS. FLOOD INSURANCE

- After this decision, the Florida Legislature revised the Valued Policy Law in 2005, and clarified that it was not intended to require an insurer to pay for a loss caused by a non-covered peril, and if a covered peril and non-covered peril cause a total loss, an insurer is only liable for damage caused by the covered peril.

- Also, under the revised law, when the covered peril alone would have caused a total loss, the insurer remains liable for policy limits regardless of other causes.

- These amendments may not be retroactively applied.

WIND INSURANCE VS. FLOOD INSURANCE

- There is pending litigation in Louisiana and Mississippi courts regarding coverage for flood damage under the standard homeowners' insurance policy as a result of Hurricanes Katrina and Rita, which occurred in 2005.

- On August 15, 2006, the United States District Court of the Southern District of Mississippi rendered an opinion in *Leonard v. Nationwide Mutual Insurance Company*, which involved a property that was damaged by a combination of wind and flood/storm surge.

WIND INSURANCE VS. FLOOD INSURANCE

- The court ruled that the policy language excluding flood coverage was valid, but that the anti-concurrent cause clause which purported to exclude coverage entirely for damage caused by a combination of the effects of water (an excluded peril) and of wind (a covered peril) was ambiguous.

- Applying Mississippi law, the court held that where the insured's property sustains damage from both wind and water, the insured may recover that portion of the loss which the insured can prove was caused by the wind and the insurer is not responsible for the portion of the damage it can prove was caused by the water.

WIND INSURANCE VS. FLOOD INSURANCE

- To the extent property is damaged by wind, and is thereafter also damaged by water, the insured can recover for that portion of the loss caused by the wind, but the insurer is not responsible for any additional loss caused by water.

- The amount of damage caused by a covered peril is a question of fact.

- This ruling will require each claimant's damages to be evaluated to determine the amount of wind damage or damage from other covered perils as compared to excluded perils.

WIND INSURANCE VS. FLOOD INSURANCE

- A federal appeals court in New Orleans has set August 6, 2007, as the date to hear oral arguments regarding Nationwide's appeal in the *Leonard v. Nationwide* case.

- Even though Nationwide considered the trial a victory, they are seeking corrections on some critical rulings made by the district court which could undermine their homeowner contract language.

- The litigation in Mississippi is ongoing and will be closely scrutinized in the upcoming months.

WIND INSURANCE VS. FLOOD INSURANCE

- The insurance industry has objected to paying any damage other than from a covered peril, arguing that insurers have not charged rates reflecting a risk for flood coverage.

- Insurers have stated that, if forced to pay for losses such as flood, an insured's premiums will rise and/or insurers may consider limiting their book of business in states with a large flood risk, such as Mississippi.

- In early August 2007 the 5th U.S. Circuit Court of Appeals in New Orleans issued another favorable ruling for insurers when it affirmed the lower court's decision in *Chauvin v. State Farm Fire & Casualty*, finding that Louisiana's valued policy law only applies if the total loss is caused by a covered peril.

CONTINGENT COMMISSIONS

- The practice of brokers and independent agents receiving commissions from insurers contingent upon sales of the insurers' policies has been a hot button issue for a number of years and is now heating up again.

- In 2004, New York Attorney General Eliot Spitzer (now New York Governor) undertook a series of investigations on this practice and eventually initiated litigation in which he went after large players in the insurance industry in an effort to reform and curtail the practice.

- Spitzer's investigations resulted in the uncovering of alleged bid rigging and steering practices by some insurers and a wide-spread system of other alleged improprieties throughout the industry.

CONTINGENT COMMISSIONS

- Spitzer alleged in the case against Marsh & McLennan Companies, Inc. that Marsh accepted money from the carriers based solely on overall business volume and did not disclose the arrangement to its clients and customers.
- The ruling resulted in a settlement for over $800 million.
- Following the Marsh settlement, the issue of broker and agent compensation received national attention and many investigations and lawsuits commenced focusing on the practice, particularly on problems with disclosure and conflict of interest.

CONTINGENT COMMISSIONS

- In light of this turmoil, the NAIC and NCOIL adopted amendments to the Producer Licensing Model Act both focusing on disclosure of compensation and a client/insured acknowledgement when the producer accepts a fee from the client/insured and a commission from the insurer in the same transaction.

- Both proposals included an exemption for wholesale intermediaries since the wholesale producer does not deal directly with the insured.

- Both proposals also exempt agents in certain circumstances, although the NCOIL model appears to be clearer in setting forth the exclusion.

CONTINGENT COMMISSIONS

- Many critics of contingent commissions were satisfied with the results of Spitzer's investigations and the promises they received from brokers and insurers that the practice would be phased out or reformed in such a way as to do away with any conflicts of interest.
- The mandatory disclosure also satisfied those who were critical of the practice.
- However, in recent months, critics are once again getting vocal on the issue as they see the continuing use of contingent commissions.

CONTINGENT COMMISSIONS

- The Risk and Insurance Management Society has stated that they will support any measures that stand firmly against contingent commissions.

- Many critics believe that as long as the practice is allowed to continue, it can be manipulated to the disadvantage of the insurance buyer.

CONTINGENT COMMISSIONS

- Groups such as PIA are calling for industry action to block regulators' enforcement of the ban on contingent commissions, saying that it is unjust to effect artificial restrictions on the ability to compensate producers in a legal and honest manner.
- Those who are for the continued practice have noted that contingent compensation is done in virtually all industries across America.
- These proponents also are quick to point out that the whole industry is being punished for the sins of a few who abused the process.
- Currently there is no legislation or regulatory action being taken on the issue.

FINITE REINSURANCE

- The use of finite reinsurance products has attracted increased regulatory scrutiny as a result of former N.Y. Attorney General (now Governor) Spitzer's high-profile investigations into the use of such products by American International Group, Inc. (AIG) and other industry heavyweights.

- The Spitzer investigations pursued alleged suspicions that AIG and others engaged in finite reinsurance transactions as a means to inflate their balance sheets or smooth out their income statements, with little to no risk transfer taking place.

- Following Spitzer's lead, many states issued subpoenas or other formal informational requests to domestic insurers seeking information regarding their use of finite reinsurance products.

FINITE REINSURANCE

- Finite reinsurance is a form of reinsurance where the insurance risk assumed is contractually limited so that the amount of a reinsurer's potential loss is confined to a relatively narrow range.
- Finite reinsurance specifically incorporates the time value of money, and the risk is reduced through accounting or financial methods, along with the actual transfer of economic risk.
- By transferring less risk to the reinsurer, an insurer receives coverage on its potential claims at a lower cost than traditional reinsurance.
- Due to the complex structure of these risk instruments, there can be abuses where no risk is transferred and the insurer's income is improved.

FINITE REINSURANCE

Common Features of Finite Reinsurance

- Utilizes time value of money in funds held in accounts to support loss reserves, similar to loss discounting;
- Provisions in contract that confine or limit the reinsurer's potential loss;
- Refund or additional premium-based loss experience;
- Slim underwriting margins with fee paid to reinsurer;
- Commutation clauses under which reinsurer refunds the premium including interest and retains a fee (2%);

FINITE REINSURANCE

- Losses emanating from multiple accident years;
- Retroactive reinsurance;
- Different accounting treatment of GAAP and SAP;
- Contract involves retrocession of risk to original cedant or its affiliate; and,
- Contract makes use of deficit accounts or experience accounts (funds held or trust agreements).

FINITE REINSURANCE

Regulators' Concerns

- Lack of disclosure in statutory statements;
- Contracts have history of being commuted;
- Side agreements or oral understandings that hide true intent of the parties to the contract;
- No clear guidance in accounting manual that defines what constitutes minimum risk transfer;
- Primary emphasis on risk financing rather than risk transfer; and,
- Allows the ceding company to attain an accounting benefit similar to loss discounting which otherwise would be prohibited.

FINITE REINSURANCE

- Because of recent abuses by several insurers, the NAIC took immediate action on the finite reinsurance issue.
- In 2005, the NAIC Property and Casualty Reinsurance Study Group adopted requirements for additional disclosures to be included in the Interrogatories portion of the statutory annual statement for year-end 2005 which was filed in March, 2006.
- If a P&C insurer answers any of the new interrogatories in the affirmative, the insurer must submit a new Reinsurance Summary Supplemental Filing form along with its annual statement.
- All P&C insurers must include with their annual statements a Reinsurance Attestation Supplement regarding their active reinsurance agreements, signed by their current CEO and CFO.

FINITE REINSURANCE

- Subsequently, the NAIC adopted a disclosure that was required for year-end 2006 financial statements.
- The NAIC Statutory Accounting Principles Working Group required these interrogatories to be audited starting with year-end 2006 reports that were due to regulators on June 1, 2007.

FOR MORE INFORMATION

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