

Florida's Ratings-Based Reinsurance Collateral Rule

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On September 16, 2008, the Florida Cabinet, sitting as the Financial Services Commission, adopted a potentially far reaching rule providing for an alternative ratings-based approach to the reinsurance collateral requirement applicable for ceding insurers to take credit for reinsurance. In essence, this rule provides for lower collateral requirements for certain reinsurers that are determined to be "eligible" by the Florida Insurance Commissioner after an application process. The amount of collateral required to take credit for the reinsurance will be based upon the credit ratings of the insurer.

The following is a more detailed summary of Florida's newly adopted ratings-based reinsurance rule:

1. What is the general background on reinsurance credit in Florida?

Under the current system in Florida and, for that matter throughout the United States, insurers are permitted to take credit on their financial statements for the reinsurance they cede based upon certain conditions being met. The credit for the reinsurance is available if the reinsurer is authorized or accredited in the State of Florida. Otherwise, the credit for reinsurance is available only if the reinsurer posts appropriate collateral under the reinsurance agreement to secure its obligations under the reinsurance agreement, which would normally include losses and loss adjustment expenses, as well as unearned premium. Typically, the assuming reinsurer, if not licensed or accredited in the State of Florida, would be required to post money or assets into a trust fund or arrange for the issuance of a bank letter of credit, both for the benefit of the ceding insurer. This law remains in place now and provides an appropriate mechanism for the insurer to obtain credit for reinsurance.

In Florida, a new ratings-based regulation was adopted by the Florida Cabinet sitting as the Financial Services Commission. The new regulation was adopted on September 16, 2008 pursuant to a change in the Florida statutes, which occurred in 2007. Under the 2007 amendment to the Florida statutes, the Insurance Commissioner has authority to establish lower collateral requirements for unauthorized and unaccredited foreign and alien reinsurers that have certain financially secure ratings from at least two (2) nationally recognized rating organizations and meet the eligibility standards of the rule.

2. What is required for the reinsurer to be authorized to post less than 100% collateral?

The reinsurer must be determined to be “eligible” by the Florida Insurance Commissioner. In addition, the ceding insurer must maintain satisfactory evidence that the reinsurer meets the solvency standards of the reinsurer’s domestic regulator. Finally, the reinsurance contract must contain certain required provisions relating to solvency; service of process; and the reinsurer’s submission to Florida jurisdiction.

3. What is required for the reinsurer to be determined to be “eligible” by the Florida Insurance Commissioner?

The reinsurer must have surplus over \$100 million; it must be authorized in its domiciliary jurisdiction for the kinds of insurance to be ceded; and its domiciliary jurisdiction must be determined to be “eligible” by the Insurance Commissioner. After review of all appropriate information, the Insurance Commissioner must decide whether the reinsurer is “eligible” and the amount of credit that may be taken without posting collateral, based on the best interests of market stability and the solvency of the ceding insurers.

4. What benefit does an “eligible” reinsurer derive under the rule?

That depends on the credit ratings of the reinsurer. Under the rule, the reinsurer would still be required to post 100% collateral for its reinsurance obligations unless it has and maintains certain minimum ratings from at least two (2) nationally recognized credit rating agencies, such as A.M. Best Company, Standard and Poor’s, Moody’s Investors Service or Fitch Ratings. Normally, 100% collateral is required. The rule defines the amount of collateral the reinsurer must post based upon its credit ratings. The higher the credit ratings, the less collateral that must be posted. As an example, the highest rated reinsurers would not be required to post any collateral and lower rated reinsurers may only have to post 10%, 20%, or 75% collateral. The rule contains a schedule of percentages of collateral required depending upon the reinsurer’s credit ratings.

5. What must be submitted with the application for eligibility?

The reinsurer is required to submit the following in an application to the Florida Insurance Commissioner:

- (a) audited financial statements;
- (b) an agreement to submit to jurisdiction in the United States and to post 100% collateral if the reinsurer resists a final judgment or fails to provide any information required by the Florida Office of Insurance Regulation (“OIR”);
- (c) a report with information pertaining to its ceding and ceded reinsurance;
- (d) a list of disputed or overdue recoverables claimed by ceding insurers; and
- (e) a certification from its domiciliary regulator that it is in good standing and that the regulator will provide any financial and operational information required by the OIR.

6. What must be determined in order to find the reinsurer’s domiciliary regulator to be “eligible?”

In order for the reinsurer to be “eligible” under this rule, the Insurance Commissioner must make a determination that the reinsurer’s domiciliary jurisdiction has eligibility status. In order to find any other jurisdiction to be “eligible” the Commissioner must determine the following:

- (a) the jurisdiction has satisfactory structure and authority regarding solvency regulation; acceptable financial and operating standards; acceptable transparent financial reports; and verifiable evidence of adequate and prompt enforcement of United States judgments and arbitration awards;
- (b) the jurisdiction has a history of performance by its reinsurers such that the public would be served by an eligibility finding by OIR;
- (c) for non-United States jurisdictions, the particular jurisdiction involved does provide United States reinsurers with comparable and favorable access to its markets as those provided by Florida to their reinsurers; and
- (d) there is no information to support a determination that a finding of eligibility would not serve the best interests of the insurance public.

If, at any point, a list of eligible jurisdictions is promulgated by the National Association of Insurance Commissioners (“NAIC”), the Insurance Commissioner in Florida can utilize that list if it is in the best interests of the public and the solvency of ceding reinsurers to do so.

The Insurance Commissioner may withdraw any eligibility determination for any jurisdiction if it is determined that such action is in the best interests of market stability and the solvency of ceding insurers.

7. What are some of the rules and criteria applicable to an “eligible” reinsurer?

Once the Insurance Commissioner determines eligibility, the reinsurer is annually required to file certifications regarding its domiciliary state license and its ratings from the applicable rating agencies; financial statements; information regarding any changes in its officers and directors; a list of disputed or overdue reinsurance claims; and other information as may be required by the OIR.

In addition, any eligible reinsurer is required to immediately advise the OIR of any changes in its license status in its state of domicile or the ratings issued by the rating agencies. The Insurance Commissioner may withdraw a determination of eligibility or require additional collateral if that would be in the best interests of market stability and the ceding insurer’s solvency.

Upon an order of rehabilitation, liquidation or conservation of a ceding insurer, the eligible reinsurer shall be required to post 100% collateral within thirty (30) days for the entire amount the cedant has taken as an asset or deduction from reserves for reinsurance recoverables. The Insurance Commissioner can withdraw the determination of eligibility for any reinsurer that fails to comply with this requirement.

8. What if the ratings of the reinsurer change?

If the ratings of the eligible reinsurer fall below the level previously approved by the OIR, credit shall be adjusted accordingly. Clearly, cedants will need to have a provision in the reinsurance contract for the posting of appropriate collateral in this situation. If the rating of the eligible reinsurer improves, that reinsurer may petition the Florida Insurance Commissioner to redetermine the amount of collateral that will be required for reinsurance ceded to that reinsurer.

9. What are some of the requirements of the ceding insurer under this rule?

The ceding insurer is required to notify OIR if its experience in collecting recoverables would indicate that the credit provided should be lower.

In addition, the ceding insurer is required to give immediate notice to OIR and increase its reserves for reinsurance recoverables if:

- (a) any of the reinsurer's obligations which are not in dispute are more than ninety (90) days past due; or
- (b) there is any indication or evidence that the reinsurer fails to substantially comply with its domiciliary state's solvency requirements.

10. What discretion does the Insurance Commissioner have under this rule?

The Insurance Commissioner has broad discretion under this rule. The Insurance Commissioner must act in the best interests of market stability and the solvency of ceding insurers. Using this standard, the Insurance Commissioner has the discretionary authority to decide the following:

- (a) whether a reinsurer should be deemed to be eligible under the rule;
- (b) whether to withdraw a determination of eligibility or the determination of the amount of collateral required;
- (c) whether a determination that any particular jurisdiction is "eligible" should be withdrawn;
- (d) whether to disallow the ceding insurer's credit for reinsurance or any portion thereof.

Further, the Insurance Commissioner can request additional information from the reinsurer at any time. The failure of the reinsurer to cooperate is grounds to withdraw eligibility status or to disallow or reduce the amount of credit the ceding insurer may take. It is important to note that the application filed by the reinsurer to become eligible must include an agreement that it will post 100% collateral if required by OIR.

Finally, broad discretion is granted to the Insurance Commissioner to not grant credit for reinsurance under the rule if he or she determines it is not in the insurance public's interest or the best interests of the ceding insurer.

11. What precipitated this rule change and who advocated in favor of it?

This rule is targeted to benefit alien reinsurers. Most alien reinsurers do not want to be licensed or accredited in the United States. Accordingly, they have always been traditionally required to post 100% collateral for their obligations under reinsurance contracts entered with United States ceding insurers.

For years, alien reinsurers have challenged the need for 100% collateralization, which has existed regardless of the financial stability of the reinsurers and the level of regulatory scrutiny imposed by their domiciliary states. In addition, there has been strong sentiment that standards in the United States are more stringent than in many other nations and that the increasing globalization of the reinsurance industry calls for a level of standardized regulation of reinsurance. It also has been argued that freeing the reinsurer's capital, which has been tied up in posted collateral under traditional reinsurance arrangements, will increase the capacity of the reinsurance market.

With regard to Florida, reinsurance capacity and pricing became significant issues after the 2004 and 2005 hurricane seasons. In the wake of these storms, the Florida Legislature created a Task Force on Long-Term Solutions for Florida's Hurricane Insurance. After multiple hearings, the Task Force found that matters pertaining to the capacity, availability and pricing of reinsurance in Florida needed to be addressed, and any artificial barriers to competition in the reinsurance market should be restricted so long as insurer solvency would not be jeopardized. At the same time, the NAIC was pursuing its initiative for the modernization of the reinsurance collateral rules.

During a Special Session held in January, 2007, the Florida Legislature changed its statute pertaining to reinsurance by providing the OIR could waive or reduce the collateral requirements for eligible reinsurers that are not authorized or accredited in Florida. This culminated with the adoption of the new ratings-based rule by the Florida Cabinet on September 16, 2008.

12. How does this rule impact reinsurers, insurers and consumers?

The impact of this rule for reinsurers and insurers will be significant. The rule will readjust how reinsurance collateral is handled in the future. This rule will apply only to those reinsurers that are not already authorized or accredited in the State of Florida. For those reinsurers, they will have the option to petition the Florida Insurance Commissioner for a determination that they are an “eligible” reinsurer so that the amount of collateral they are required to post will be reduced or eliminated depending upon their credit ratings. This will significantly alter collateralization requirements for those reinsurers. Theoretically, this will enhance the capital investment and deployment options available to these reinsurers.

Many argue that increased capacity of foreign capital will be available to be reinvested in Florida and other states that adopt a ratings-based rule. This increased capacity would ultimately benefit consumers. At the hearing of the Cabinet on September 16, 2008, when the rule was approved, Florida Insurance Commissioner Kevin McCarty commented that he felt lower premiums would be marginal based upon the adoption of this rule, but the adoption of this rule sends a positive message to the international reinsurance community that Florida is actively promoting competition in its reinsurance market.

Some have argued this change will potentially jeopardize the integrity and solvency of ceding insurers impacted by the rule. This could be particularly true for smaller, single state insurers that may not have negotiating leverage to require collateral when not required or will have to pay a premium for that benefit.

The current collateral requirements provide assurance that their reinsurance collectables will be paid. If 100% collateral is not required, ceding insurers may be required to pursue reinsurance claims to recover the sums due and may be required to proceed in non-United States jurisdictions to collect on those claims. In addition, the assets that would have otherwise been posted as collateral for reinsurance recoverables may be utilized for other purposes, which could potentially jeopardize the solvency of the reinsurers. By the time solvency issues are discovered, it may be too late for the Florida regulators or the ceding insurer to take protective action that will assure that the ceding insurer will be made whole. Potentially, this could jeopardize reinsurance collectibles and force cedants to negotiate settlements they would not have agreed to if they had 100% collateral. These types of issues could jeopardize the solvency of certain ceding insurers and lead to liquidations and guarantee fund payments. This could result in assessments by the guarantee fund on all Florida insurance consumers. It is argued all of this will occur even though it is unlikely that reinsurance rates will drop as a result of this rule.

13. Does this rule have any impact on the Florida Hurricane Catastrophe Fund?

The Florida Hurricane Catastrophe Fund (FHCF) acts as a state-backed reinsurer for Florida residential property carriers. The FHCF is not required to post collateral. Because of that, it will not be directly affected by the changes in the collateral rule.

Under Florida law, the FHCF provides certain layers of mandatory reinsurance coverage that must be purchased by Florida residential property carriers. It also currently offers other layers of voluntary coverage that may be purchased. The pricing for some of these coverages are generally viewed to be less than pricing on the open voluntary market. The FHCF has the authority to assess Florida policyholders if it has insufficient funds and bonding capacity available in order to pay its reinsurance obligations. In essence, the Florida insurance public is at risk for any losses sustained by the FHCF. The pricing discounts available from the FHCF increase this risk.

If sufficient additional private reinsurance capacity becomes available within the market at pricing deemed appropriate by the policymakers in Florida, it is possible the Legislature could eventually reduce the reinsurance capacity available from the FHCF. Private market capacity could eventually be available to replace some of the coverage now provided by the FHCF. Of course, this will be dependent upon the pricing and availability of the reinsurance from the private market.

14. How does this relate to current insurance issues on the federal level?

There have been a number of bills proposed in Congress that would provide for a federal backstop for catastrophes such as hurricanes, tornadoes, earthquakes and the like. None of the bills have been passed as of now. These bills typically provide for federal or state-consortium reinsurance or federal, low interest loans. These bills are based upon the premise that sufficient, well-priced voluntary market reinsurance capacity is not available to cover the most significant of catastrophic risks. Any efforts to increase the voluntary market capacity for reinsurance could impact any proposed federal legislation which may be considered in Congress.

15. Where is the NAIC on this issue?

The Reinsurance Task Force of the NAIC has been holding meetings and considering comments on its proposed rule, which would provide for a reduction in the collateral requirements applicable to “eligible” reinsurers. The updated Reinsurance Regulatory Modernization Framework Proposal was approved by the Task Force during the NAIC Fall 2008 National Meeting held in September, 2008. The proposal also was approved by the NAIC Financial Condition Committee at the same meeting. The proposal will now proceed to NAIC Plenary for consideration during the next scheduled NAIC meeting in December, 2008. In many respects, this rule is very similar to the Florida rule.

16. How does this impact other states?

The rule is specifically limited to Florida. It provides that it does not affect the laws of any other state and all insurers must comply with the laws in any other states in which they do business.

New York and Texas are proceeding with rule development on comparable ratings-based reinsurance collateral rules. Other states will be closely watching the results in Florida and New York, as well as NAIC developments on its model law. It appears this ratings-based reinsurance collateralization approach is gaining momentum and all within the industry need to be familiar with and ready to address these changes.

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