

***The Impact of an Optional Federal Charter
On the Reinsurance Collateral Debate –
The Latest Red Herring***

Gregory S. Arnold, LL.M

**(508) 688-4119
gregarnoldesq@yahoo.com**

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I. Introduction

Standards and practices in the field of reinsurance regulation and supervision vary widely among jurisdictions. Prudential approaches span from direct supervision of reinsurers, to supervision through cedants, to little or no supervision at all. The supervision of reinsurance is experiencing a convergence in significant jurisdictions, including the European Union and the United States. Important topics include the anticipated single passport to Europe and, in the United States, the reinsurance collateral debate and the potential move toward an optional federal charter. Who is behind these issues, and do the issues share common ground?

The European Union (“E.U.”) is progressing toward a single, open market for reinsurance and a federalized system of reinsurance regulation. Important principles of mutual recognition and at least minimal harmonization of rules are some of the important foundations being implemented to make that system work. If and when the Reinsurance Directive is implemented, it will result in the complete elimination of reinsurance collateral requirements among E.U. Member States, although E.U. Member States will still be able to impose such requirements on reinsurers from countries outside the E.U.

Some E.U. spokespersons have suggested that the United States (“U.S.”) should learn from the E.U. experience and adopt a federal system of reinsurance regulation in lieu of the current state-based system of regulation. These commentators suggest there would be a nexus between a federal system of regulation in the U.S. and the abolishment of U.S. reinsurance collateral requirements.

In the U.S., collateral from unauthorized reinsurers satisfies “credit for reinsurance” regulations of the insurance departments in the various states. This places reinsurers that are required to post collateral at a competitive disadvantage compared to those that are not required to post collateral. This leads to capacity issues and provides ceding insurers fewer reinsurance options.

This paper surveys the reinsurance regulatory schemes of the E.U. and the U.S. For the law of the E.U., the article discusses the Reinsurance Directive as it pertains to the ability of E.U. insurers to require the “pledging of assets” by third-country reinsurers, including those domiciled in the U.S. The analysis of law in the U.S. will include Congressional Acts, an NAIC Model Law, the current law of New York State, and a discussion of the regulatory proposal by New York State. The latter is intended to soften the collateral requirements, lead to mutual recognition, and set the ground work for minimal harmonization of rules among unauthorized reinsurers and New York State.

The balance of the article appeals to the historian and scholar of insurance law. Lloyd’s is an insurance market with its head office in the U.K., one of the Member States of the E.U. Because Lloyd’s is a strong proponent of elimination of collateral requirements in the U.S, this section reviews the failure of the old “Lloyd’s of London,” along with legacy issues that have concerned U.S. insurance regulators. The new “Lloyd’s” is then studied in view of its current self-regulation initiatives, the increasingly robust governmental oversight from the nascent, yet impressive Financial Services Authority, and the treatment given Lloyd’s by the rating agencies.

The article then provides an historical overview of the arguments for and against an optional federal charter in the U.S., with an analysis tailored to the purpose of this paper, which is to refute the unfounded notion that an optional federal charter would herald the elimination of reinsurance collateral requirements in the U.S.

Finally, this article provides some context to consider the emerging issues with respect to whether the requirement of collateral from unauthorized reinsurers is a violation of the World Trade Organization’s General Agreement on Trade in Services or any provisions of the United States Constitution.

II.

The Reinsurance Collateral Debate

Current Regulatory Scheme in the United States

The history of insurance and reinsurance regulation in the United States has been one of resistance to the notion of federal regulation of the business of insurance. Each time Congress has passed legislation dealing with the subject of insurance regulation, it has confirmed its delegation of power to the states so they can continue to regulate the business of insurance. Such has been the case with both the McCarran-Ferguson Act and the Gramm-Leach-Bliley Act.

The McCarran-Ferguson Act (15 U.S.C. § 1012(b))

No Act of Congress shall be construed to invalidate, impair, or supersede any law enacted by any State for the purpose of regulating the business of insurance, unless such Act specifically relates to the business of insurance: Provided, That after June 30, 1948, the Act of July 2, 1890, as amended, known as the Sherman Act, and the Act of October 15, 1914, as amended, known as the Clayton Act, and the Act of September 26, 1914, known as the Federal Trade Commission Act, as amended (15 U.S.C. 41 et seq.), shall be applicable to the business of insurance to the extent that such business is not regulated by State Law.

The Gramm-Leach-Bliley Financial Services Modernization Act

The Gramm-Leach-Bliley Act¹, or “GLBA”, was passed in 1999 for the following purpose:

To enhance competition in the financial services industry by providing a prudential framework for the affiliation of banks, securities firms, insurance companies, and other financial service providers, and for other purposes.

Of significance for purposes of this article are two sections. Sec. 104 of Title I of GLBA states as follows:

Title I – Facilitating Affiliation Among Banks, Securities Firms, and Insurance Companies

Sec. 104. Operation of State Law

(a) State Regulation of the Business of Insurance.—The Act entitled “An Act to express the intent of Congress with reference to the regulation of the business of insurance” and approved March 9, 1945 (15 U.S.C. 1011 et seq.) (commonly referred to as the “McCarran-Ferguson Act”) remains the law of the United States.

¹ Text of the act available online at http://frwebgate.access.gpo.gov/cgi-bin/getdoc.cgi?dbname=106_cong_public_laws&docid=f:publ102.106, last viewed March 10, 2009.

Title III – Insurance

Sec. 301. Functional Regulation of Insurance

The insurance activities of any person (including a national bank exercising its power to act as agent under the eleventh undesignated paragraph of section 13 of the Federal Reserve Act) shall be functionally regulated by the States, subject to section 104.

Credit for Reinsurance Laws and Regulations

Ensuring consumer protection through promoting the solvency of primary insurance companies, or cedants, is a focal point of insurance regulation. Regulators establish rules to ensure that cedants have adequate funds available to respond to claims. When a cedant enters into a reinsurance transaction with a reinsurer, the assets of the reinsurer become one source of funds to satisfy the obligations of the ceding insurance company to policyholders. One means by which insurance regulators guard against insolvency of cedants is to exercise control over the reinsurers operating in their jurisdictions. Following the lead of the National Association of Insurance Commissioners, all states and the District of Columbia have enacted legislation disallowing credit for reinsurance unless a reinsurer is either authorized or, if unauthorized, has posted collateral security for obligations assumed from ceding insurers.

NAIC Credit for Reinsurance Model Law

The starting point for understanding reinsurance collateral security requirements (hereinafter simply “reinsurance collateral”) is the National Association of Insurance Commissioner’s (“NAIC’s”) Credit for Reinsurance Model Law (CFRML), which is quoted below. The NAIC is a voluntary organization composed of insurance commissioners from the various states and the District of Columbia. While a voluntary trade organization, it has been criticized as being a “private legislature”.²

1. Purpose of Credit for Reinsurance Model Law (“CFRML”)

The text of the “Purpose” of the Credit for Reinsurance Model Law (CFRML) is set forth verbatim below:

The purpose of this Act is to protect the interest of insureds, claimants, ceding insurers, assuming insurers and the public generally. The legislature hereby declares its intent is to ensure adequate regulation of insurers and reinsurers and adequate protection for those to whom they owe obligations. In furtherance of that state interest, the legislature hereby provides a mandate

² See Susan Randall, *Insurance Regulation In The United States: Regulatory Federalism and the National Association of Insurance Commissioners*, 26 Florida State University Law Review, Spring 1999, at 647 (“The substantial body of literature developed in the last decade dealing with the phenomenon of the “private legislature” in the context of uniform law revision provides some useful insight into the issues raised by the NAIC’s role in drafting model insurance laws and regulations...”. See also, at 647, “The NAIC membership is composed of state officials with regulatory powers and responsibilities in their respective states, who may also wield substantial influence in their own state’s legislatures and who are individually accountable to their governors, or in some cases, to the electorate.”

that upon the insolvency of a non-U.S. insurer or reinsurer that provides security to fund its U.S. obligations in accordance with this Act, the assets representing the security shall be maintained in the United States and claims shall be filed with and valued by the state insurance commissioner with regulatory oversight, and the assets shall be distributed, in accordance with the insurance laws of the state in which the trust is domiciled that are applicable to the liquidation of domestic U.S. insurance companies. The legislature declares that the matters contained in this Act are fundamental to the business of insurance in accordance with [15 U.S.C. §§ 1011-1012](#).³

2. Credit Allowed a Domestic Ceding Insurer Under Section 2, CFRML

The text of § 2, Credit Allowed a Domestic Ceding Insurer, is voluminous. It occupies six pages of the CFRML, which itself is a twenty-five page document. The preamble to § 2 is set forth verbatim below:

Credit for reinsurance shall be allowed a domestic ceding insurer as either an asset or a reduction from liability on account of reinsurance ceded only when the reinsurer meets the requirements of Subsections A, B, C, D or E of this section. Credit shall be allowed under Subsections A, B or C of this section only as respects cessions of those kinds or classes of business which the assuming insurer is licensed or otherwise permitted to write or assume in its state of domicile or, in the case of a U.S. branch of an alien assuming insurer, in the state through which it is entered and licensed to transact insurance or reinsurance. Credit shall be allowed under Subsections C or D of this section only if the applicable requirements of Subsection F have been satisfied.

An “alien assuming insurer”, in this particular context meaning a non-U.S. reinsurer that is “entered and licensed to transact insurance or reinsurance” in at least one U.S. state, can operate within the U.S. under this § 2 without the requirement to post reinsurance collateral. In such a case, the U.S. ceding insurance company, or “domestic ceding insurer”, is allowed credit for that reinsurance as either (a) an asset on its books or as (b) a reduction from liability on its books, on account of the reinsurance ceded to such non-U.S. reinsurance company. If all non-U.S. reinsurance companies took advantage of this licensing option under CFRML § 2, there would be no reinsurance collateral debate, and hence, no need to analyze such collateral requirements in terms of whether they violate the World Trade Organization’s General Agreement on Trade in Services

Oddly, this § 2 receives no recognition whatsoever in the criticisms lodged against the U.S. reinsurance regulatory framework by critics, mostly from the E.U. The most vocal of such criticism comes from the U.K., and most of that comes from individuals intimately connected with Lloyd’s.⁴

³ NAIC Model Laws, Regulations and Guidelines 785-1, § 1, available through purchase from the National Association of Insurance Commissioners. The reference to 15 U.S.C. §§ 1011-1012 is to the McCarran-Ferguson Act of 1945. The use of the word “fundamental” is important in the analysis of the prudential carve-out, discussed *supra*.

⁴ For a lighthearted look at the “red herrings” and “elephants in the room” connected with this debate, see Gregory S. Arnold, PowerPoint Slide Presentation, *The Impact of an Optional Federal Charter on the Reinsurance Collateral Debate – The Latest Red Herring*, slides 10 thru 19, 2009, available online at http://works.bepress.com/gregory_arnold/, last viewed March 10, 2009.

3. Credit Allowed a Domestic Ceding Insurer Under Section 3, CFRML

Those non-U.S. reinsurers who are not licensed or otherwise permitted to operate in the U.S. under § 2 are nevertheless permitted access to U.S. markets by complying with the requirements of NAIC CFRML § 3, the text of which is shown verbatim below:

Asset or Reduction from Liability for Reinsurance Ceded by a Domestic Insurer to an Assuming Insurer not Meeting the Requirements of Section 2

An asset or a reduction from liability for the reinsurance ceded by a domestic insurer to an assuming insurer not meeting the requirements of Section 2 shall be allowed in an amount not exceeding the liabilities carried by the ceding insurer. The reduction shall be in the amount of funds held by or on behalf of the ceding insurer, including funds held in trust for the ceding insurer, under a reinsurance contract with the assuming insurer as security for the payment of obligations thereunder, if the security is held in the United States subject to withdrawal solely by, and under the exclusive control of, the ceding insurer; or, in the case of a trust, held in a qualified U.S. financial institution, as defined in Section 4B. This security may be in the form of:

A. Cash;

B. Securities listed by the Securities Valuation Office of the National Association of Insurance Commissioners and qualifying as admitted assets;

C. (1) Clean, irrevocable, unconditional letters of credit, issued or confirmed by a qualified U.S. financial institution, as defined in Section 4A, effective no later than December 31 of the year for which the filing is being made, and in the possession of, or in trust for, the ceding company on or before the filing date of its annual statement;

(2) Letters of credit meeting applicable standards of issuer acceptability as of the dates of their issuance (or confirmation) shall, notwithstanding the issuing (or confirming) institution's subsequent failure to meet applicable standards of issuer acceptability, continue to be acceptable as security until their expiration, extension, renewal, modification or amendment, whichever first occurs; or

D. Any other form of security acceptable to the commissioner.

As described in § 3 above, a non-U.S., unlicensed, unauthorized reinsurer becomes authorized to reinsure domestic insurance business in the U.S., by posting reinsurance collateral in the form of cash (including funds held from the non-U.S., unlicensed reinsurer by the domestic ceding insurer), securities meeting certain qualifications, irrevocable letters of credit, and/or “any other form of security acceptable to the commissioner”.

The purpose of this paper is to discuss whether the reinsurance collateral requirements recommended by the NAIC in § 3 of the CFRML, and as adopted by the various states to varying

degrees, is unfair competition and discriminatory against unauthorized reinsurers. A related issue is whether such collateral requirements are a violation of WTO GATS. This paper provides an historical overview of the controversial background of the reinsurance collateral debate.⁵ Whether the U.S. should or should not adopt an optional federal charter or other federal intervention in competition with state regulation of insurance is a separate inquiry from whether an optional federal charter would or would not lead to relaxation or elimination of collateral requirements.⁶ As explained later in this paper, efforts are progressing by the NAIC and some states, most notably New York and Florida, to relax reinsurance collateral requirements; which efforts themselves involve complexities with respect to enforcements of judgments and mutual recognition of non-U.S. regulatory regimes, and therefore beg ever expanding analysis, much of which is touched upon in this paper.

B. Summary of the Above NAIC Rules

1. Summary of CFRML Rules

By way of summary, credit for reinsurance reduces reserves by the amount of exposure ceded to reinsurance, and is allowed under the NAIC CFRML as follows:

- The reinsurer is licensed in the same state of domicile as the ceding insurance company; or
- The reinsurer is accredited by the domiciliary insurance department of the ceding insurance company; or
- The reinsurer is domiciled and licensed in a state with similar credit for reinsurance laws as the ceding company; or
- The reinsurer maintains trust funds in the U.S.; or
- The ceding insurance company withholds funds, or receives security such as irrevocable letters of credit from, the reinsurer.

2. Summary of NAIC Accreditation Requirements

To satisfy NAIC accreditation requirements, a reinsurer must do the following:

- Maintain policyholder surplus of at least \$ 20 million;
- File an annual financial statement in the ceding insurance company's state of domicile;
- Be licensed in at least one state;
- Submit to enacting state's examining authority;
- Submit to enacting state's administrative, civil and criminal jurisdiction.

⁵ For a review of the history of the collateral debate, see Robert B. Kasinow, Chief Insurance Examiner, New Jersey Department of Banking and Insurance, Slide Presentation on *Reinsurance Regulatory Modernization*, Financial Summit, 2008 Leadership Initiatives, undated, *Available* online at http://www.naic.org/documents/frs_summit_presentations_29.pdf, last viewed March 10, 2009.

⁶ For a perspective on whether the U.S. should adopt reforms leading to greater federal involvement in the field of insurance, see Michael Haravon, *Federalism of Insurance/Reinsurance, A Good Idea?*, *Journal of Reinsurance*, Vol. 13 No. 3, Summer 2006, *available* online at http://www.milbank.com/NR/rdonlyres/AC030C67-0C1B-474C-B7C9-9F3BCAF76AA9/0/0607142_haravon.pdf, last viewed March 10, 2009.

Regulators distinguish between “authorized” reinsurers that are not required to post collateral and “unauthorized” reinsurers that are. Authorized insurers are licensed by and pay taxes in one or more states and/or the District of Columbia, each with its own requirements with respect to credit for reinsurance.⁷ Credit for reinsurance involves the ability of cedants to offset case reserves and unearned premium reserves by the amount of risk ceded to reinsurance companies. By either statute or administrative practice,⁸ most states allow financial statement credit for reinsurance transactions with reinsurers licensed in the same state, or reinsurers licensed in another state where the company meets the solvency requirements of the state where the credit is taken. Regulators permit cedants to rely upon the authorized status of these reinsurers simply by referencing the name and NAIC number of the reinsurer in the annual statements and other financial statements of the cedant.

In contrast, the credit for reinsurance laws require unauthorized reinsurers to post collateral for purposes of consumer protection and solvency protection of their cedants. The collateral takes the form of trust funds, letters of credit, or funds withheld, all discussed below. Their collateral requirements are the subject of much discussion in the insurance community, even to the point of whether the requirements are necessary in any form.

Unauthorized reinsurers, including both foreign reinsurers and those domiciled in but not licensed in the U.S., can participate in the U.S. marketplace on an authorized basis, without collateral requirements, simply by becoming licensed, therefore admitted, in the states in which they wish to do business. Unauthorized reinsurers post collateral pursuant to regulator-imposed rules, which can be satisfied, at least partially, by contractual arrangements with cedants. As stated by New York State Insurance Superintendent Eric Dinallo, “[N]othing prevents insurance companies from negotiating their own collateral requirements or from choosing to do business with reinsurers who are willing to put up collateral, if that is what the insurance company prefers.”⁹

Insurance regulation in the United States is unique in comparison with other countries discussed in this paper, because the business of insurance in the United States has historically¹⁰ been regulated by the insurance departments¹¹ of the respective states. As more fully discussed in Sections II and III of this paper, the authority of states to regulate insurance, to the exclusion

⁷ See, e.g., *Report of the National Association of Insurance Commissioners (NAIC) and the Federal Reserve System Joint Troubled Company Subgroup: A Comparison of the Insurance and Banking Regulatory Frameworks for Identifying and Supervising Companies in Weakened Financial Condition*, Apr. 19, 2005, Appendix A-3 (“Credit for reinsurance is heavily regulated through statutes, regulations, statutory accounting and reporting rules”), available at <http://www.federalreserve.gov/boarddocs/staffreports/naicfrs/naicfrs.pdf>, last viewed March 10, 2009.

⁸ *Id.*

⁹ *N.Y. Moves to Level Playing Field on Collateral for All Reinsurers*, Insurance Journal, Oct. 18, 2007 (“*Level Playing Field*”), available at <http://www.insurancejournal.com/news/national/2007/10/18/84395.htm>, last viewed March 10, 2009. This point is reinforced by Robert B. Kasinow, Chief Insurance Examiner for the New Jersey Department of Banking and Insurance, “A point worth noting is collateral can always be obtained in the negotiating process between two parties, the primary insurer and reinsurer.” See “Kasinow March 9, 2009 letter”, *supra*, note 9.

¹⁰ With the exception of a period of less than one year, following the case of *United States v. South-Eastern Underwriters Assn.*, 322 U.S. 533 (1944) (“*Southeastern Underwriters*”), which prompted enactment of the McCarran Ferguson Act of 1945, U.S.C. §§ 1011-1015 (“MFA”), confirming the federal grant of power to the states to regulate the business of insurance.

¹¹ Insurance commissions were established by New Hampshire in 1851, (N.H.Laws 1851, c. 1111); by Massachusetts in 1852 (Mass.Laws 1852, c. 231); by Rhode Island in 1855 (R.I.Laws, October 1854, p. 17, s 17). By 1890, when the Sherman Act became law, seventeen states had established supervisory authorities. Patterson, *The Insurance Commissioner in the United States* (1927) p. 536, n. 62. As cited in *Southeastern Underwriters*, *supra* note 10, dissent at page 1189.

of the federal government, was unqualifiedly confirmed initially in the 1868 case of *Paul v. Virginia*¹², and then codified in the McCarran-Ferguson Act, which included certain exceptions related to anti-trust activities. “[I]t has been the insistent position of the Congress that regulation of the insurance industry be left to the states.”¹³ With Congress going to great lengths to avoid federal regulation of insurance, the insurance departments of the various states developed their own sets of rules and procedures for protection of policyholders through solvency, rate and form regulation. The authority of the McCarran-Ferguson Act was confirmed as recently as the 1999 enactment of the Gramm-Leach-Bliley Act.

The reinsurance collateral debate, as discussed at world conferences and in the industry press, does not involve issues of anti-trust, and there are no legal issues involving the courts.¹⁴ The study of insurance regulation often involves tension between governmental agencies and the courts, but there are no such issues in this debate. This debate is one involving economics and politics, and in particular, the increasingly successful efforts of unauthorized reinsurers to effect insurance regulatory reform in the U.S. The tension in this debate exists between reinsurers from various countries and the insurance regulators of the individual U.S. states.

Unauthorized reinsurers argue that, if collateral requirements were eliminated, the increased capacity would be \$2 billion or 1.3% globally.¹⁵ These costs, and related discrimination arguments from unauthorized reinsurers, serve as the major points of contention in the debate over whether unauthorized reinsurers should be required to post such collateral. These same unauthorized reinsurers make no reference to whom is really picking up the cost of the reinsurance collateral requirements.

*There is no doubt that there are costs involved with maintaining [letters of credit] and trust funds and while the actual (cost) is funded by the reinsurer, it is built into the price paid by the buyer for reinsurance coverage. Many U.S. ceding insurers view these balances as a small price to pay for the added security provided by collateral, whatever form it takes.*¹⁶

Prominence of New York State in the Reinsurance Collateral Debate

The insurance regulations of New York State are especially important in the analysis of the reinsurance collateral debate. New York is a leader in the field of insurance regulation in the United States and is “...the most prominent reinsurance business center in the United States...”¹⁷ New York City is regarded as one of the world’s major financial capitols and, through its Appleton Rule,¹⁸ controls what insurance companies in other states can and cannot do. For the foregoing reasons, the insurance regulations of New York, and regulatory reform proposals from

¹² *Paul v. Virginia*, 75 U.S. (8 Wall) 168 (1868).

¹³ *Mackey v. Nationwide Insurance*, 724 F.2d 419, at 423 (1968).

¹⁴ The imposition of reinsurance collateral requirements should not be confused with the more recent efforts to fashion understandings with foreign countries for the relaxation or elimination of collateral requirements, which could involve litigation between the federal government and one or more states.

¹⁵ *U.S. Reinsurance Collateral White Paper*, report of the National Association of Insurance Commissioners Reinsurance Task Force of the Financial Condition (E) Committee (“NAIC”), March 5, 2006, (hereinafter simply “NAIC White Paper”), at 28.

¹⁶ *Id.* at 27.

¹⁷ See Robert M. Hall, *Pre-Answer Security and Reinsurance Arbitrations*, available at <http://www.robertmhall.com/articles/Pre-AnswerArt.htm>, last viewed March 10, 2009.

¹⁸ A provision of the New York Insurance Code requiring insurance companies licensed in that state to follow specific New York laws even when operating outside of the state. N.Y. Ins. L. § 1106. Violation can result in the suspension or termination of the operations of a New York-licensed insurer. *Id.*

New York's insurance regulator, will be used as examples in this analysis of the reinsurance collateral debate.

The analysis of the New York example will start with current insurance regulation, followed by a discussion of the counter-arguments in the reinsurance collateral debate. The section will close with a review of New York's past treatment of unauthorized reinsurers and of a proposed reform that would reduce reinsurance collateral requirements.

Current New York State Insurance Regulations – Regulation No. 20 (11 N.Y.C.R.R. 125).

In order for an unauthorized reinsurer to be “accredited” or permitted by the New York State Department of Insurance (“NYSID”) to operate as an authorized reinsurer, it must meet the collateral requirements set forth in Regulation No. 20, which states in pertinent part as follows:

(c)(1) In the case of an alien [i.e., unauthorized] assuming insurer, not otherwise entered as a United States branch in another state, such assuming insurer meets the standards of solvency required of licensed insurers of like character, such terms and conditions as prescribed by the superintendent, and otherwise complies substantially with related requirements, and such assuming insurer has deposited and continues to maintain in one or more New York state banks and/or members of the Federal Reserve System located in New York state, a trust fund or trust funds, constituting a trust surplus, in cash, readily marketable securities, or letters of credit, in an amount of not less than \$20,000,000 for the protection of the United States insurers, and United States beneficiaries under reinsurance policies (contracts) issued by such alien assuming insurers. Such trustee amount shall be in addition to any other trust fund required by this department, including, but not limited to, a trustee amount at least equal to the liabilities attributable to United States insurers and United States beneficiaries under reinsurance policies (contracts) issued by such alien assuming insurers.¹⁹

Regulation 20 references two specific categories of collateral (discussed below), followed by another category of collateral required specifically of a “Lloyd’s plan.” One category is the “trustee amount” in the sum of liabilities under individual reinsurance contracts with ceding insurers. Individual ceding companies often require such collateral in their respective, private reinsurance arrangements with reinsurers, both authorized and unauthorized, and this category of collateral is not the subject of regulation in New York.

The other category of collateral is the trust surplus funds in the amount of \$20,000,000 per unauthorized reinsurer, as a surplus over and above each unauthorized reinsurer’s liabilities under individual reinsurance contracts. For unauthorized reinsurers which (other than Lloyd’s - previously “Lloyd’s of London”), it is this trust fund requirement that is the crux of the reinsurance collateral debate.

Finally, in the case of “a group located outside the United States whose members consist of individuals incorporated assuming insurers who are not engaged in any business other than

¹⁹ Available at http://www.ins.state.ny.us/r_finala/2003/pdf/fr20a9tx.pdf. A proposed revision would qualify the regulation’s initial reference to “alien assuming insurer” to mean “non-U.S. assuming insurer,” and for the balance of (c)(1) substitute “non-U.S. assuming insurer.” This is presumably a response to the sensitivity of European reinsurers who take offense to the word “alien.” See proposed revision, available at <http://www.ins.state.ny.us/press/2007/rp071018rein.pdf>. This proposed change is in addition to more sweeping reforms proposed by the NYSID, and discussed later in this article, starting on page 21.

underwriting as a member of the group and individual unincorporated assuming insurers” (referring to Lloyd’s-style reinsurers without mentioning any company or market names), there is an additional requirement of trust surplus funds in the amount of \$100,000,000.²⁰ Lloyd’s has always been a market, not a company or insurance corporation, and it thus appears this section is in reference to Lloyd’s.

Thus, Lloyd’s is required to post collateral equal to (a) liabilities under reinsurance contracts, plus (b) trust surplus funds in the amount of \$20,000,000, plus (c) trust surplus funds in the amount of \$100,000,000. Therefore, as discussed later in this section, it is not surprising that Lloyd’s is the most vocal opponent of U.S. reinsurance collateral requirements, and the leader of the pan-European effort to abolish such requirements.

Description of Authorized Collateral Types and Options

New York law permits several methods of collateralizing reserves for unauthorized reinsurers. The most popular methods are single beneficiary trusts and letters of credit (“LOCs”), followed by multiple beneficiary trusts, funds held, and ceded balances options. “*The vast majority of reinsurance collateral is funded via trusts or LOCs that are negotiated with an individual beneficiary.*”²¹ It is presumed that reinsurers, cedants and state insurance regulators take account of those private dealings when determining what balance of funds must be trusted with the state insurance regulators.

a. Single Beneficiary Trusts (SBT’s)

Under the NAIC Model Laws and the implemented laws of New York and other states, a ceding insurer obtains credit for reinsurance ceded to an unauthorized reinsurer to the extent of funds held in a trust acceptable to the insurance regulator for the exclusive benefit of the ceding insurer as security for the payment of obligations under the reinsurance agreement. This vehicle is known as a single beneficiary trust, or SBT.

b. Letters of Credit (LOC’s)

The use of LOC’s has become predominant over trusts, as the maintenance costs have fallen.²² Cedants and regulators prefer the relative ease of negotiating LOC’s, which are backed by the credit of the bank and not that of the reinsurer. A failure of a bank to honor an LOC exposes the bank to sanctions under federal law.

According to the *U.S. Reinsurance Collateral White Paper* report of the National Association of Insurance Commissioners (“NAIC”) (“*NAIC White Paper*”), the acquisition cost of an LOC is between 40 to 60 basis points.²³ Also, there are associated bank charges from drawing down an LOC.²⁴ These are significant enough to incline a reinsurer to pay a claim from

²⁰ Regulation No. 20 §125.4(c)(5)(d)(1)(iv)(a), available at http://www.ins.state.ny.us/r_finala/2003/pdf/fr20a9tx.pdf.

²¹ *NAIC White Paper*, *supra*, note 15, at 10.

²² See *TheTruthAboutLloyd’s*, a web site of the American Names Association, which has a distinctly advocate tone and orientation, in favor of American Names and against Lloyd’s, available at <http://TruthAboutLloyds.com>.

²³ *NAIC White Paper*, *supra*, pages 9 and 27. A basis point is a unit of measure used in finance to describe the percentage change in the value or rate of a financial instrument. One basis point is equivalent to 0.01% (1/100th of a percent) or 0.0001 in decimal form.

²⁴ *Id.*, at 14.

other available funds. This further advances the convenience interests of cedants and regulators, because the party that draws down on an LOC has some administrative paperwork in preparing sight drafts and cover letters, and in tracking deadlines. When a reinsurer pays with separate funds, the beneficiary/cedant can simply advise the reinsurer and issuing bank that the cedant releases any interest in the LOC. As an alternative, the LOC can remain in place to secure other, or future, obligations of the same reinsurer to the same cedant.

c. Multiple Beneficiary Trusts (MBT's)

Multiple beneficiary trusts (“MBTs”) are another means by which unauthorized reinsurers may meet their collateral requirements. These are more expensive to administer and, as mentioned above, in addition to the calculated reserve requirements per individual reinsurance contract, unauthorized reinsurers are required to fund a trust surplus account of \$20,000,000.²⁵ Lloyd’s syndicates must collectively fund an additional trust surplus reserve account in the amount of \$100,000,000.²⁶ As an illustration of the market share of Lloyd’s, as of December 2004, Lloyd’s credit for reinsurance MBTs were valued at \$7.39 billion, compared with non-Lloyd’s MBTs valued at \$7.14 billion.²⁷ This market share helps explain why Lloyd’s is so conspicuous in making demands of the insurance regulators in the U.S. to change their regulations with respect to reinsurance collateral requirements.

Unlike LOCs, MBTs are not easy for cedants or liquidators to negotiate. The *NAIC White Paper* stresses the following difficulties:

*Companies must go through the entire claims process first in order to put a claim into the trusts. For example, liquidation officers have indicated that the process of collecting from a MBT is extensive, expensive and time consuming. Unlike a LOC, which can be quickly and easily drawn and collected upon, it can take years and significant expense to collect from a MBT. The process of collecting from Lloyd's MBT is first to meet the contractual requirements for submitting proofs of loss, which almost no reinsurer honors for an insolvent cedent, requiring many rounds of documentation and explanation far beyond contractual requirements. When the cedent finally loses patience at this vexatious conduct, an arbitration demand is the only resort. After getting an award (which can take 18 months to 2 years), they must file for a confirming award in a court and weather possible appeals. Once you have an unappealable award you must initially try to collect from Names, and then the Central Fund, all without success, and then finally you try to access the Lloyd's MBT. What liquidator or cedant in their right mind would go through that process.*²⁸

d. Funds Held Accounts

For the purpose of a reinsurer’s satisfying the required trust surplus accounts, a reinsurer can agree to the “funds held” option. Rather than funding a LOC in a private arrangement with a cedant or placing trustee accounts with a regulator, reinsurers can agree to permit cedants to maintain premiums at the ceding company level. Cedants in this case do not remit funds to the

²⁵ NYSID Regulation 20.

²⁶ *Id.*

²⁷ *NAIC White Paper, supra*, page 10, citing data received from the New York State Department of Insurance as of Dec. 31, 2004.

²⁸ *Id.*, at 13. NYSID Regulation 20, *supra*, notes 25 and 26, specifically requires one-hundred percent collateral of reinsured obligations with respect to cedants in liquidation.

reinsurer *via* an immediate payment or bordereau²⁹ credit transaction. This can involve considerable opportunity cost for the reinsurer, because the latter loses the potential investment income on the premium it would have otherwise received in the normal course of business (unless netted out partially or wholly in a bordereau transaction). Thus, the funds held option must be carefully weighed against the various collateral alternatives discussed in this section.

e. Ceded Reinsurance Balances Payable

According to the NAIC White Paper, one type of collateral is “ceded balances”.³⁰ The term is not defined in the NAIC White Paper. One definition is as follows: “Ceded balances payable is a liability account presented net of regular ceding commission.”³¹ Of all collateral types, the NAIC White Paper shows ceded balances comprise 5.5%, with trust accounts at 39.8%, LOC’s at 32.3%, Funds Held at 18.9%, and “Misc.” at 3.5%.³²

B. Proposed Reinsurance Regulatory Reform in the United States

Potential Optional Federal Charter – the “National Insurance Consumer Protection and Regulatory Modernization Act” forthcoming 2009

The proposed National Insurance Consumer Protection and Regulatory Modernization Act is expected to be introduced in Congress any day now by Rep. Melissa Bean, D-Illinois., and Rep. Ed Royce, R-California. The extent to which this differs from the failed proposal of the National Insurance Act of 2007 (hereinafter simply “NIA”)³³ remains to be seen, as the text of the bill has not been publicly released for review and analysis. *Ergo*, resort is made here solely to the NIA, with presumptions about what will be included in the new bill.

The NIA was introduced with the goal of establishing an optional federal charter (“OFC”), which would have allowed insurance companies to choose to be regulated by a newly created federal insurance regulatory authority, rather than by the current state-based regulation of insurance.³⁴

The stated purpose of the NIA was to bring “*uniformity and predictability to how life and property/casualty insurance is regulated.*”³⁵ “*Neither the House nor the Senate version made it out of committee.*”³⁶

²⁹ A report by an insurance company to its reinsurer listing and summarizing certain insurance transactions affecting the reinsurance.

³⁰ See NAIC White Paper, *supra*, “Figure 4 – Collateral by Type”, showing “Ceded Bal.” “% of Total” “5.5”, at 10.

³¹ See http://www.actuarialoutpost.com/actuarial_discussion_forum/showthread.php?p=2751688.

³² NAIC White Paper, *supra*, at 10.

³³ S. 40 (2007); H.R. 3200 (2007).

³⁴ Federal involvement in the field of insurance is not new. Despite McCarran-Ferguson and the repeated affirmations that insurance regulation should be by the various states, as is consistent with BLBA 1999, federal involvement in insurance regulation is seen in providing terrorism and flood coverage; implementing of TRIA in 2002; forcing states to create reciprocity laws for agents under GLBA; providing social insurance such as Social Security, Medicare and unemployment compensation (administered by the states); and overseeing the actions of the states, as was the charge of the House Financial Services Committee during the 108th Congress. See Trends in Insurance Regulation, Baranoff, Etti G., Review of Business, Sept. 22, 2003, available online at <http://www.allbusiness.com/business-finance/business-insurance/713585-1.html>, last viewed March 8, 2009.

³⁵ Press Release, note 102, *infra*.

³⁶ *Top Insurance Stories in 2007*, December 31, 2007, Insurance Journal, Available at <http://www.insurancejournal.com/news/national/2007/12/31/86018.htm>.

The legislation is expected to be reintroduced by the different name, but by the same sponsors. Representatives Bean and Royce “...said the bill would be different from prior drafts because it would call for tough protection of consumers and would work in concert with a system-wide regulator for financial service that is being discussed in Congress and by the Obama administration.”³⁷ According to the Chief Insurance Examiner for the New Jersey Department of Banking and Insurance, “(u)nlike other bills an Office of National Insurance would be opened in each state to handle consumer complaints.”³⁸

This author expects the 2009 legislation to be very similar to the 2007 version, plus the announced strengthening by language providing for consumer protection. The new proposal, like the old, is not necessarily expected to provide insurers with an option, or alternative, to be regulated by the federal government rather than multiple state governments. According to the Chief Insurance Examiner for the New Jersey Department of Banking and Insurance:

*Questions on this bill also involve whether insurers really would have a choice. Word has it the “optional” was never a political reality previously and seems to be absent in this bill. The potential for mandatory federal legislation is viewed as troublesome for many OFC supporters. The down side is dual regulation. The news is filled with the failure of dual regulation from the banking side.*³⁹

It is anticipated that the latest version, like its failed predecessor, would be based upon the assumption that insurers choosing to be regulated by one, federal supervisor would experience benefits of unbundling in terms of saving on costs and time in the filing of rates and forms, delivering insurance products, and generally complying with various other regulations now promulgated by multiple state regulators.

As with the earlier version of an OFC, it is anticipated that, in the new version, the federal government would provide charters to “national insurance companies” and to “federally licensed reinsurers” and a federally licensed reinsurer, licenses to agents and brokers, and regulate the business of a national insurer. It is expected that, again using the dual federal banking system as a model, the new version will propose that the states continue taxing the business of insurance conducted within their borders. In addition, state law would regulate guarantee funds, unclaimed property under escheat laws, participation in assigned risk plans and other mandatory residual market mechanisms, and compulsory coverage of workers' compensation or motor vehicle insurance.

It is anticipated by this author that the 2009 version will included language similar to the 2007 Senate proposal⁴⁰ with respect to contemplation of trust accounts and credit for reinsurance, as follows:

³⁷ “Plans For U.S. Insurance Regulation Bill Unveiled”, Arthur D. Postal, *National Underwriter Online News Service*, Feb. 11, 2009.

³⁸ See “Kasinow March 9, 2009 letter”, *supra*, note 9.

³⁹ *Id.*

⁴⁰ Available at <http://thomas.loc.gov/cgi-bin/query/C?c110:./temp/~c110di6omP>.

Title II – National Insurance Companies and National Insurance Agencies

Subtitle A – Organization, Licensing, and Operations

Sec. 1202. United States Branches of Non-United States Insurers

(a) Authorization of Non-United States Insurer.-

A non-United States insurer may transact insurance in the United States through a United States branch by qualifying and licensing the United States branch to do business as a national insurer under this Act, under such regulations as the Commissioner may prescribe.

*(b) **Trust Account** –⁴¹*

(1) In General –

The Commissioner shall not license a United States branch until the non-United States insurer establishes a trust account, pursuant to a deed of trust that meets the requirements of this section. (Bold emphasis added).

Subtitle C - Reinsurance

SEC. 1222. Credit for Insurance Ceded by a National Insurer or Federally Licensed Reinsurer

(a) Credit for Insurance Ceded to a National Insurer or a Federally Licensed Reinsurer-

A national insurer may establish an asset or reduce its liabilities, to the extent of such liabilities, for insurance ceded to another national insurer or federally licensed reinsurer.

(b) Other Asset or Reduction From Liability for Insurance Ceded-

A national insurer may establish an asset or reduce its liabilities, to the extent of such liabilities, for insurance--

(1) that is ceded to--

(A) a State insurer;

(B) a United States branch entered through a State; or

(C) a non-United States insurer; and

(2) if such insurance is ceded consistent with the standards established by the Commissioner pursuant to subsection (c)

*(c) Regulation- **The Commissioner shall establish, by regulation, standards governing insurance ceded by a national insurer, as the Commissioner may determine to be necessary to protect the policyholders of a national insurer. (Bold emphasis added).***

⁴¹ Sec. 3, “Definitions”, describes “Trusteed Assets” as follows: “The term ‘trusteed assets’ means, with respect to a United States branch, assets required or permitted by this title to be deposited by a non-United States insurer with a qualified trustee for the security of its policyholders and creditors in the United States”.

The House of Representatives version of the 2007 bill⁴² was similar. The provision that the “*Commissioner shall establish, by regulation, standards governing insurance ceded by a national insurer*”, and the express requirement in Sec. 1202 for the establishment of a trust account, gives the proposed federal regulator the ready framework and express power to impose collateral requirements upon reinsurers. Since the sponsors of the 2009 measure promise even more consumer protection, it is reasonable to assume that the inclusion of this framework, allowing for imposition of trust accounts /collateral upon reinsurers, will be even more demanding upon unauthorized reinsurers than in the 2007 version.

The language of the NIA 2007, and anticipated language of the 2009 version, are relevant to the collateral debate. Both the House and Senate versions of the stalled National Insurance Act of 2007 contained references to trust accounts. Parenthetically, the both also referred to “*collateral*,”⁴³ but not in the context of credit for reinsurance. Cedants (referred to in the bills as “*national insurers*”) may rely on reinsurance provided by “*another national insurer or federally licensed reinsurer*.”⁴⁴ The source of the reinsurance (domestic or foreign) does not matter provided it “*is ceded consistent with the standards established by the [to-be-established National Insurance] Commissioner*.”⁴⁵ These standards are addressed to **security** “*in order to protect the policyholders of a national insurer*” and are to be established by regulation.⁴⁶ (Bolding added). The 2007 version of the NIA was supported by the Reinsurance Association of America,⁴⁷ which has historically been a proponent of collateral requirements.⁴⁸

There was no language in the House or Senate versions of the NIA 2007 to suggest that a federal charter would lead to suppression of U.S. collateral requirements for unauthorized reinsurers. To the contrary, the bills, as previously introduced, literally set forth a framework for imposition of collateral (“*security*”) requirements. This is consistent with treatment of reinsurance under current state regulation - not a major departure to be embraced by

⁴² Available at <http://thomas.loc.gov/cgi-bin/query/F?c110:1:./temp/~c110yIhvI3:e215505>

⁴³ The references to “collateral” are found in Section 33 “Policyholder”, “The term ‘policyholder’ does not include a person with a mere beneficial interest in an insurance policy or a person to whom an insurance policy is assigned for collateral security purposes” and Sec. 1605, “Claims Covered For Policyholders Of National Property/Casualty Insurers”, sub-Sec (d) “Insurance Lines Excluded – This title shall not provide coverage on claims for... (4) credit insurance, vendors single interest insurance, or collateral protection insurance or any similar insurance protecting the interests of the creditor arising out of a creditor-debtor transaction,...”. See full text of S. 40, available online at <http://www.govtrack.us/congress/billtext.xpd?bill=s110-40>.

⁴⁴ E.g., S. 40 § 1222(a). Also, see Subtitle C – Reinsurance, Sec. 1221(d)(1)(2), “For purposes of this subsection, a federally licensed reinsurer shall be deemed to be a National Insurer under subtitle C of title I.”

⁴⁵ *Id.* § 1222(b)(2).

⁴⁶ *Id.* § 1222(c).

⁴⁷ See Press Release, *Sununu, Johnson: Marketplace Demands Insurance Regulatory Reform. Senators re-introduce "National Insurance Act" to respond to the needs of America's insurers and consumers*, May 24, 2007. Available at <http://sununu.senate.gov/pressapp/record.cfm?id=275014>. Other supporters of the National Insurance Act, according to this Press Release, include “the Agents for Change, the American Bankers Association, the American Bankers Insurance Association, the American Council of Life Insurers, the American Insurance Association, the Council of Insurance Agents and Brokers, the Financial Services Forum, the Financial Services Roundtable, the Life Insurers Council, the National Association of Independent Life Brokerage Agencies.”

⁴⁸ See, e.g., letter from Reinsurance Association of America to Commissioner John Oxendine, NAIC, September 21, 2007, available at http://www.naic.org/documents/committees_e_reinsurance_comments_RAA.pdf. See also a “Kasinow March 7, 2009 letter”, *supra*, note 9, “Note that the RAA is basically supportive of the Reinsurance Framework as it allows for a single state regulator thus easing dealing with multiple state regulators and also has collateral percentages that give some benefit to U.S. reinsurers.”

unauthorized reinsurers hoping for a break from what they argue are discriminatory and anti-completive collateral requirements. With the proposed legislation containing words such as “standards” and “security”, and with the 2009 version adding tougher consumer protection language, it is logical to predict that the final version of the legislation, if it ever passes, will allow for imposition of collateral upon unauthorized reinsurers assuming reinsurance from U.S. cedants.

C. Reinsurance Regulatory Scheme in the European Union

The business of primary or direct insurance⁴⁹ has some history of regulation in Europe, while the business of reinsurance has been mostly unregulated. Now, reinsurance regulation in Europe is experiencing a convergence.⁵⁰ This is due to approval of a November 2005 law known as the Reinsurance Directive.⁵¹ The approval was given by the European Parliament, which is the legislative body of the European Union (“E.U.”).

The Reinsurance Directive

The Reinsurance Directive is the result of E.U. efforts toward a unified regulatory and supervisory market for reinsurance. If the latest revised schedule holds, the majority of the E.U. member states will incorporate the Reinsurance Directive into their respective national laws no later than October 2008.⁵²

The Reinsurance Directive contains three essential provisions, including (1) the establishment of a single “passport” to Europe,⁵³ (2) the elimination of collateral requirements

⁴⁹ The first insurance company in England was established in 1696. This was a company called Contributors for Insuring Houses, Chambers or Rooms from Loss by Fire by Amicable Contributionship, or “Amicable Contributionship.” It was nicknamed “Hand-in-Hand” because of its fire mark, one hand clasping another, symbolizing aid and assistance. See Mutual Assurance Society of Virginia, available at <http://www.mutual-assurance.com/newInsInAmerica.asp>.

⁵⁰ One commenter on this refers to this as a “global regulatory maelstrom” [tumultuous changes in global regulation of (re)insurance] spreading across Europe. The phrase implies sweeping and universally accepted change, which is not necessarily the case. See David Howell, Swiss Re, *The Global Regulatory Framework*, Global Conference of Actuaries, Feb. 15, 2005, New Delhi.

⁵¹ Directive 2005/68/EC of the European Parliament and of the Council of 16 November 2005 on reinsurance and amending Council Directives 73/239/EEC, 92/49/EEC as well as Directives 98/78/EC and 2002/83/EC, available at http://www.eur-lex.europa.eu/LexUriServ/site/en/oj/2005/l_323/l_32320051209en00010050.pdf.

⁵² According to Professor Pierpalo Marano, this is not realistic, at least for Italy, which is concentrating on soft insurance law and will not be able to implement the Reinsurance Directive until at least 2009. February 14, 2008 lecture, Insurance Regulation in the E.U. course, University of Connecticut School of Law, Hartford, CT.

⁵³ The ability to conduct reinsurance business throughout Europe on the basis of a single authorization from a reinsurer’s home member state.

within the E.U.,⁵⁴ and (3) prudential⁵⁵ rules for the supervision of reinsurance companies and finite reinsurance.⁵⁶

In studies known as “*Solvency I*” and “*Solvency II*,” commissioned by Europe’s executive body, the European Commission, the focus was on prudential rules relating to assessment of risk management, finance methods, accounting, supervision, actuarial analysis and practices, and financial reporting. Studies have been protracted and frustrated with compromise, an example of which is inclusion in the Reinsurance Directive of “*optional*” provisions relating to finite reinsurance.⁵⁷ According to one observer, this “*is but the latest example of the sheer impossibility of Europe agreeing on a common vision pertaining to specific aspects of reinsurance.*”⁵⁸

The Reinsurance Directive contains three provisions concerning reinsurance dealings with third countries, such as the U.S. These are Article 26 of Title III, Conditions Governing the Business of Reinsurance, and Articles 49 and 50 of Title VI, Reinsurance Undertakings Whose Head Offices Are Outside the Community and Conducting Reinsurance Activities in the Community.

Article 26, Cooperation Agreements With Third Countries, provides for the concluding of cooperation agreements with competent authorities of third countries regarding the exchange of information.⁵⁹ The Article provides for guarantees of secrecy for the disclosure of information. In the U.S. the competent authorities are the insurance regulators of the various States. Such exchange of information is intended only for the performance of the supervisory tasks of the respective regulatory bodies.

Article 49, Principle and Conditions for Conducting Reinsurance Business, forbids a Member State from applying to reinsurers having their head offices outside the E.U. and operating in the E.U., provisions resulting in “*treatment more favourable than that accorded to reinsurance undertakings having their head office in that Member State.*”⁶⁰

⁵⁴ Referred to as “pledged assets” in Article 32 of the Reinsurance Directive. “Member States shall not retain or introduce a system with gross reserving which requires pledging of assets to cover unearned premiums and outstanding claims provisions if the reinsurer is a reinsurance undertaking authorised in accordance with this Directive or an insurance undertaking authorised in accordance with Directives 73/239/EEC or 2002/83/EC.”

This arguably leaves open the possibility of requiring collateral of U.S. reinsurers. These “pledged assets” are sometimes referred to as “deposit accounts.” See for example Ralph Vogelgesanga and Matthias Kubicek, *Toward a Global Approach to Reinsurance Regulation*, The Geneva Papers (2007) 32, 413-425, available at <http://www.palgrave-journals.com/gpp/journal/v32/n3/full/2510136a.html>.

⁵⁵ Defined as exercising prudence, good judgment, or common sense.

⁵⁶ “Finite reinsurance” defined in Article 2 (q) of the Reinsurance Directive, as “reinsurance under which the explicit maximum economic risk transferred, arising both from a significant underwriting risk and from a timing risk transfer, exceeds the premium over the lifetime of the contract by a limited but significant amount, together with at least one of the following two features: (i) explicit and material consideration of the time value of money, (ii) contractual provisions to moderate the balance of economic experience between the parties over time to achieve a target risk transfer..”

⁵⁷ Recital number 31 of the Reinsurance Directive states “This Directive should be applicable to finite reinsurance activities; therefore, a definition of finite reinsurance for the purposes of this Directive is necessary; owing to the special nature of this line of reinsurance activity, the home Member State should be given the option of laying down specific provisions for the pursuit of finite reinsurance activities. These provisions could differ from the general regime laid down in this Directive on a number of specific points.”

⁵⁸ Michael Haravon, *The Harmonization of European Reinsurance: In Whose Interest?*, National Underwriter, Property & Casualty / Risk & Benefits Management Edition, Sept. 5, 2005.

⁵⁹ Reinsurance Directive, art. 26.

⁶⁰ *Id.*, art. 49.

Article 50, Agreements With Third Countries, sets forth rules by which the European Commission may submit proposals to the European Council for the negotiation of agreements with third countries regarding the means of exercising supervision of (a) reinsurers which have their head offices in a third country, and conduct reinsurance business in the E.U., and (b) reinsurance undertakings which have their head offices in the E.U. and conduct reinsurance business in a third country.⁶¹ In particular, these agreements shall “... *seek to ensure under conditions of equivalence of prudential regulation, effective market access for reinsurance undertakings in the territory of each contracting party and provide for mutual recognition of supervisory rules and practices on reinsurance.*” This article also provides for ensuring that the competent authorities of the contracting parties “... *are able to obtain the information necessary for the supervision of reinsurance undertakings*”

Finally, Title VII, Subsidiaries of Parent Undertakings Governed by the Laws of a Third Country and Acquisitions of Holdings by Such Parent Undertakings, provides for the provision of information from Member States to the Commission and addresses third country treatment of E.U. reinsurance undertakings.⁶² Article 52 requires that Member States “...*inform the Commission of any general difficulties encountered by their reinsurance undertakings in establishing themselves and operating in a third country or carrying on activities in a third country.*”

Prior to the Reinsurance Directive, reinsurance regulation in Europe has not been uniform. For example, “*France has enacted only a few supervisory rules that essentially regulate the market entry of reinsurance entities, and some of which have not even been fully implemented.*”⁶³ France has used collateral as a proxy to direct reinsurance regulation, creating extra costs for foreign reinsurers doing business in that country.⁶⁴ “*Hannover Re, a German company, for example, estimated that additional charges and administrative costs linked to collaterals added \$618 million annually to operating costs.*”⁶⁵

This has resulted in criticism of France as being discriminatory against reinsurers from other E.U. member states. Sufficient pressure was applied by the E.U. to force France to agree to abandon its collateral requirements effective October 2008.⁶⁶ It remains to be seen whether France will cooperate.

As for reinsurance in the United Kingdom, change has come, and more change is certain. Lloyd’s and the London insurance market in general have gone from no external regulation⁶⁷ to

⁶¹ *Id.*, art. 50.

⁶² *Id.*, arts. 51, 52.

⁶³ Haravon, *supra* note 35.

⁶⁴ Countries requiring collateral are: U.S.; Canada; France; Germany (Life Insurance only); and Portugal. As planned, France and Portugal eliminate collateral requirements October 2008, per anticipated full implementation of the Reinsurance Directive.

⁶⁵ Haravon, *supra.*, notes 35 and 38, citing to the French economic paper, La Tribune, on Feb. 12, 2004. Compare to the reported \$500,000 transactional costs for all alien reinsurers combined to operate in the United States. News Centre, *Credit For Reinsurance, What It Means for Lloyd’s*, available at http://www.lloyds.com/News_Centre/Credit_for_reinsurance/What_it_means_for_Lloyds.htm, Last Updated on 26 Jul 2007.

⁶⁶ Conspicuous by its absence is any prohibition in the European Directive preventing member states from applying collateral requirements to non-E.U. businesses. See Insurance and Reinsurance News, Freshfields Bruckhaus Deringer, July 2005.

⁶⁷ As stated by one Name, “We know the 300-year-old history; it was like the monarchy. That was our mistake. Lloyd’s failed us and it should not be allowed to regulate itself any more.” See Cathy Gunn. *Nightmare on Lime Street : whatever happened to Lloyd's of London?*, Smith Gryphon Publishers, London, page 148 (1993).

regulation by the Financial Services Authority (“FSA”) starting in 2002. Only time will tell what has really changed at Lloyd’s other than its name (it is now simply “Lloyd’s”).⁶⁸ Even Alistair Tosh, one of the officials at the FSA, admits that the FSA’s regulatory efforts *vis-à-vis* Lloyds are in the “infancy stage.”⁶⁹ As a result, and with particular regard to Lloyd’s, it may be premature for U.S. regulators to assume that the business of reinsurance is now regulated to such an extent in the United Kingdom, France and the E.U. generally, that American regulators should have confidence that the solvency of their insurers is protected, thus permitting a wholesale abandonment of reinsurance collateral requirements.

D. Framing the Debate – Competing Arguments Regarding Reduction or Elimination of Reinsurance Collateral in the United States

1. Level Playing Field Issue

The most frequent phrase encountered in the reinsurance collateral debate is “level playing field.” Alien reinsurers claim the U.S. collateral rules unfairly discriminate against them such that there is not a level playing field.⁷⁰

State law requires the posting of collateral if a cedant wants or needs to take credit for reinsurance transactions. New York’s Regulation 20 mandates collateral from alien and domestic unauthorized reinsurers, but ceding companies, at their own discretion, can waive it. However, without such collateral, the ceding company is not permitted to take advantage of the accounting and statutory benefits of “*credit for reinsurance*” as against surplus. Breaking it down, it appears the focus of alien reinsurers is the requirements of trusteed funds in the amount of \$20,000,000 and, in the case of Lloyd’s, an additional \$100,000,000.

The U.S. response to this part of the collateral debate is discussed throughout the balance of this paper.

Origin of E.U. Reform s – E.U. Member State vs. E.U. Member State

The E.U. Reinsurance Directive includes suppression of an E.U. reinsurance company collateral requirement because the reinsurers in the member states desire to eliminate collateral for commercial or economic reasons. The provision was not an inevitable result of the single passport to Europe, which might be viewed as a corollary to an optional federal charter (“OFC”) in the U.S. The prohibition of the collateral requirement in Europe came as a result of the desired integration of the European Market. Maintenance of collateral requirements among E.U. members impedes the freedom of services within the E.U., thus the Reinsurance Directive makes much sense for Europe.

E.U. Hope for Transport of E.U. “Federal-Like” Experience

⁶⁸ According to Martin Leach of Lloyd’s, the new company paid ten million pounds to the consultant that came up with the new name, which simply amounted to dropping “of London.” Presentation by Martin Leach at the Lloyd’s Building, as part of the London Insurance Markets course, on location in London, U.K., The University of Connecticut School of Law, Insurance Law Center, Mar. 13, 2007.

⁶⁹ Presentation by Alistair Tosh, Financial Services Authority, to the London Insurance Markets course, on location in London, The University of Connecticut School of Law, Insurance Law Center, Mar. 12, 2007.

⁷⁰ If alien reinsurers are making distinctions between the required trusteed funds and the collateral demanded by cedants in their respective contractual arrangements, it is in private conversations and not making it to the press.

to the U.S. Reinsurance Collateral Debate

Articles commenting upon this collateral debate make statements such as “U.S. and foreign reinsurers agree that the dispute over the fairness of U.S. collateral requirements for alien reinsurers can be mitigated by the availability of an optional federal charter.”⁷¹ These articles do not give objective reasons why this should be so. Alien reinsurers certainly cannot point to their own experience with reinsurance reform and claim that they have done away with reinsurance collateral requirements among themselves, or that they have a comprehensive reinsurance regulation for all of Europe. Such articles thus appear to make conclusory statements or arguments, and do not fairly advance the debate.

Despite unmet and rescheduled deadlines, the apparent stubbornness of France, the difficulty in building sufficient consensus and momentum, and other shortcomings, the E.U. reinsurers claim to have made great strides toward uniformity in their approach to reinsurance regulation. Alien reinsurers hope to expand that perceived momentum to the U.S., with a design to suppress, or eliminate, collateral requirements, as if the U.S. should want “to be like” the Europeans.

Credit for reinsurance laws, with variations from State to State, are at the heart of the collateral controversy. The E.U. has threatened action against the U.S. before the World Trade Organization unless the U.S. drops its strict rules governing foreign, unauthorized reinsurers. As early as September 11, 2001, Lloyd’s Chairman, Lord Peter Levene, was calling for a significant overhaul of the U.S. trust fund requirements relative to non-U.S. reinsurers.⁷² “Following the Sept. 11 attacks Lloyd’s says it had to come up with over \$3 billion in 6 months.”⁷³ Levene noted as follows:

*[T]he reinsurance industry is essentially global and as such 80 percent of the reinsurance utilized by the U.S. primary market is supplied by companies outside of the U.S. Alien insurers are being discriminated against and that is totally unacceptable. ... What is happening at the moment amounts to protectionism and the market wants to see a level playing field.*⁷⁴

⁷¹ David Pilla, *Agreeing To Disagree: In a Best’s Review Roundtable About U.S. Collateral Requirements, Reinsurers Clash On U.S. Regulation, But United On The Need For Universal Rules*, Best’s Review, Dec. 1, 2006. Contrast the more logical argument that E.U. reforms regarding collateral might have some impact on U.S. reforms regarding collateral, short of any suggestion that this would be accomplished through enactment of a federal charter in the U.S. See Meg Green, *Alien Forces at Work (Regulation: Reinsurance / Capital Markets*, Best’s Review, Aug. 1, 2005. “Now that the European Union has agreed to a single reinsurance protocol to regulate the industry, some say the United States will face increased pressure to simplify its regulatory structure, including reducing or eliminating its collateral requirements for foreign reinsurers doing business within its borders.” Available at http://goliath.ecnext.com/coms2/gi_0199-4613154/Alien-forces-at-work-Regulation.html. See also *Face to face: the forthcoming Reinsurance Directive will be a factor as renewal talks begin in Monte Carlo in September*, A.M. Best Company, Inc., 2006, available at <http://www.thefreelibrary.com/Face+to+face:+the+forthcoming+Reinsurance+Directive+will+be+a+factor+...+a0149508523>. “The Reinsurance Directive will end collateralization within the European Union, something that is likely to strengthen the argument from Europe for an end to collateralization requirements in the United States.”

⁷² *Insurers Again Call for U.S. Reinsurance Collateral Changes at World Insurance Forum*, Insurance Journal, Feb. 24, 2006.

⁷³ *Id.*

⁷⁴ *Id.*

Those who closely follow this collateral debate view both Lloyd's, and the U.K. lobby in general, as the primary sources for the anti-collateral campaign in the U.S.⁷⁵ As discussed in Section E, New York State's insurance regulator is listening, and proposing reforms that should meet most of the demands of the alien reinsurers.

Unfair, Anti-Competitive Regulation

Alien reinsurers argue that maintaining collateral, reserved to burdensome “*gross liabilities*” standards, is unfair and anti-competitive. When assets are not allocated where they are most needed, the result “... *is inefficient, costly, and gives an unfair preference to some customers at the expense of others.*”⁷⁶ The “*gross liabilities*” argument may not be accurate with respect to trust funds, as the combined exposures of each alien reinsurer, on a contract-by-contract, exposure-by-exposure basis, would likely far exceed the statutory collateral requirements, and collateral balances are not always effectively monitored by the various States. On the other hand, “*gross liabilities*” may be accurate with respect to cedants in receivership or liquidation, as one-hundred percent collateral is required from unauthorized reinsurers in such cases. This allocation issue goes to the diversification point addressed below.

Those in favor of the *status quo* argue that “*the purpose of the collateral requirements is not simply to have assets within the United States, but to have them where they are accessible to the ceding company and to regulators if there is a dispute or if the reinsurer is simply unwilling or unable to pay.*”⁷⁷ Collection difficulties would be exacerbated if assets were located outside the U.S., requiring pursuit under foreign judicial systems with the associated delays and added expense of obtaining and enforcing judgments on foreign soil. The issue of enforcement of foreign judgments is discussed in greater detail *infra*.

The U.S. stakeholder's view is that the U.S. credit for reinsurance system is not discriminatory because it provides options that are available to both U.S. and non-U.S. entities.”⁷⁸ Non-U.S. reinsurers have several alternative options to avoid collateral requirements. They can become licensed, form a branch, become accredited, or form a subsidiary operation in the U.S.⁷⁹ Due to high costs of licensing and taxes, these alien reinsurers prefer to operate offshore as unauthorized reinsurers. This comes at the consequential cost of posting collateral when dealing with state regulators in the U.S.

Lloyd's does not have the option of domesticating or becoming licensed in the U.S. because of its unique structure – a market rather than a company. The legal framework and capital structure of Lloyd's is discussed below.

Failure to Properly Reserve and Unrecoverable Reinsurance

⁷⁵ See The Truth About Lloyd's, *supra*, note 19.

⁷⁶ NAIC White Paper, *supra*, at 32.

⁷⁷ *Id.*, at 32.

⁷⁸ *Id.*, at 37. Thus, not a violation of the 1977 World Trade Organization (WTO) regime for liberalizing trade in financial services, including insurance and reinsurance. WTO has no jurisdiction over state regulatory authorities and does not tell governments how to conduct their trade policies. WTO only has a direct impact on a government's policies where disputes are brought to it for resolution.

⁷⁹ See, e.g., NAIC White Paper, at 29.

“(U)nrecoverable reinsurance has been an ingredient in some of the largest insurance insolvencies.”⁸⁰ A major component of (re)insurance company insolvency is a failure to adequately reserve for losses, with prime examples being Lloyd’s of London and HIH Insurance Group of Australia⁸¹.

“The British tax regime was partly to blame for the state of affairs at Lloyd’s.”⁸² The structure of that tax regime was such that the very wealthy faced incredibly high income tax rates. It thus made sense to join Lloyd’s for tax purposes, *i.e.*, to pay cash calls and obtain favorable tax treatment based upon such participation. “‘Lloyd’s had not written insurance for profit for years’, said one former underwriter in 1972.”⁸³ Accordingly, at least until quite recently, U.S. insurance regulators have had mistrust for Lloyd’s. It does appear that Lloyd’s, under its new name and management, along with governmental oversight from the nascent FSA, has shown improvement in its business management and operations. This is likely to be influencing the NYSID in its proposed reinsurance reforms (discussed below).

Enforceability of U.S. Judgments Overseas

The U.S. State Department claims there is a problem with enforcement of valid U.S. judgments in foreign jurisdictions. “[T]he law and practice in most foreign countries is not generally favorable to the prompt, predictable enforcement of U.S. civil judgments.”⁸⁴ “There is no international counterpart to the ‘full faith and credit’ clause of the U.S. Constitution.”⁸⁵ Experts engaged in assisting clients to collect from reinsurance companies in certain parts of the world struggle with first obtaining a judgment in one country, and then domesticating that judgment in another where they are lucky to have some comity and uniformity of judicial systems, and then finally attempting to collect on the domesticated judgment.⁸⁶

A frequent debate topic is “the historical difficulties of collecting reinsurance recoverables from non-U.S. reinsurers in the case of a cedant’s insolvency ...”⁸⁷ “Receivers

⁸⁰ *Id.*, at 11.

⁸¹ Australia’s “second largest general insurer,” “largest corporate insolvency in Australia’s history,” failing in part for “under-reserving,” plus mismanagement and failure of corporate culture. See Slide Pages 21-28, KPMG Insurance Solutions: *The conduct of insurance company insolvency in the UK*, Presentation to the University of Connecticut School of Law, Tom Riddell and Michael Maccallum, Mar. 15, 2007, Advisory [hereafter “KPMG Insurance Solutions”], on file with the author. This is not a peculiarly Australian or European problem, as domestic, authorized and unauthorized companies in the U.S. have failed for the same or similar reasons.

⁸² *Nightmare on Lime Street*, *supra* note 43, at page 34.

⁸³ *Id.*, page 34.

⁸⁴ *NAIC White Paper*, *supra*, page 34. But, consider some practical realities of enforcement. During questions and answers following a briefing at the Peace Palace, The Hague, Netherlands, by President and Judge Rosalyn Higgins of the International Court of Justice on September 23, 2008, Judge Higgins noted that a would be recalcitrant party is counseled to comply with a judgment enforcement order, because that same Respondent may some day wish to be an Applicant to the ICJ on its own case. American Bar Association, International Legal Exchange Delegation to the Hague, September 21-23, 2008.

Other factors that may encourage compliance with foreign judgment enforcement include various treaties requiring a county to be in good stead with court proceedings. With respect to Memoranda of Understanding between and among regulators of various countries, one party might cancel said MOU with respect to another, depriving same of expected benefits, such as relief on collateral requirements, in response a regulator’s refusal to honor a foreign court judgment regarding reinsurance recoverables.

⁸⁵ *Id.*, page 34.

⁸⁶ *KPMG Insurance Solutions*, *supra*, note 55.

⁸⁷ *NAIC Members “Dialogue” with European Commission, Supervisors: CEIOPS Hosts NAIC-EU Regulation Dialogue in Frankfurt*, International Report, Issue No. 19, Mar. 2005, NAIC, available at http://www.naic.org/documents/committees_g_spring05_int_report.pdf.

have reported that having access to collateral makes a tremendous difference in the collection process, both in getting timely responses to billings and other correspondence as well as tempering the extreme positions taken by some reinsurers.”⁸⁸

NYSID Proposed Reform – Memorandum of Understanding On Enforcement of Judgments

As part of the reforms suggested by the NYSID, collateral requirements will be relaxed for alien reinsurance companies that “Accept required contract terms, including consent to the jurisdiction of U.S. courts for disputes” and “Have a primary regulator that has a memorandum of understanding with the NYSID that addresses information sharing and considers such matters as regulatory equivalency and enforceability of judgments.”⁸⁹ Whether a memorandum of understanding that “considers such matters as ... enforceability of judgments” equates with actual recognition and enforcement of judgments may be an open issue. Perhaps the insurance regulators in the E.U. member states will find a way to overcome the hurdles presented by international enforcement of judgments, which hurdles have not been overcome even by the ambitious Hague Convention on Choice of Court Agreements.

Hague Convention on Choice of Court Agreements

The *NAIC Collateral White Paper*⁹⁰ suggests that the Hague Convention on Choice of Court Agreements, adopted by the Hague Conference on Private International Law on June 30, 2005 (hereinafter “Convention”), may lead to better enforcement of judgments related to reinsurance contracts in the international marketplace:

Although many efforts have been made over the years to negotiate more comprehensive international treaties for mutual recognition of judgments, significant differences between legal systems have caused negotiators to narrow their focus. Nevertheless, despite its limited scope, a recently negotiated treaty represents a significant step forward, since if it is implemented, it will allow the parties to control the forum in which contractual disputes are resolved.⁹¹

One of the limitations on the international enforcement of reinsurance treaties, at least in the U.K., is the U.S. requirement of pre-appearance security. Most states in the U.S. have pre-appearance security statutes, the majority of which are based on the NAIC Model Unauthorized Insurers Process Act adopted in 1949. That act does not use the term “reinsurer” or “reinsurance.” It uses the term “unauthorized insurer.” The purpose of the act is as follows:

The purpose of this Act is to subject certain insurers to the jurisdiction of courts of this state in suits by or on behalf of beneficiaries under insurance contracts. The legislature declares that it is a subject of concern that many residents of this state hold policies of insurance issued or delivered in this state by insurers while not authorized to do business

⁸⁸ *NAIC White Paper, supra*, at 34.

⁸⁹ *Level Playing Field, supra*, note 9.

⁹⁰ *NAIC Collateral White Paper, supra*, at 35.

⁹¹ *Id.* at 35. This is referring to the Hague Choice of Courts Agreement Convention. See also Anthony J. Woodhouse, *The Importance of Jurisdiction and Choice of Law Clauses: A European Perspective*, 42 *Tort Trial & Ins. Prac. L.J.* 1027 (2007), which discusses service of suit and arbitration clauses, but not enforcement of judgments, in the U.K., U.S., Australia and France. Pages 1031-1032 discuss the English Civil Jurisdiction and Judgments Act of 1982 and the Civil Procedure Rules, concluding that “The rules on jurisdiction over insurance contracts do not apply to reinsurance.”

in this state, thus presenting to these residents the often insuperable obstacle of resorting to distant forums for the purpose of asserting legal rights under these policies.

As to a remedy, the act provides:

Before any unauthorized foreign or alien insurer shall file or cause to be filed any pleading in any action, suit or proceeding instituted against it, the unauthorized insurer shall deposit with the clerk of the court in which the action, suit or proceeding is pending, cash or securities or file with the clerk of the court a bond with good and sufficient sureties, to be approved by the court, in an amount to be fixed by the court sufficient to secure the payment of any final judgment which may be rendered in the action; or procure a certificate of authority to transact the business of insurance in this state.

Several states have adopted pre-appearance security statutes which are variations on the act. New York's statute requires that security be deposited with the court but provides that "the court may in its discretion, make an order dispensing with such deposit or bond if the superintendent certifies to it that such insurer maintains within this state funds or securities in trust or otherwise sufficient and available to satisfy any final judgment which may be entered in the proceeding"⁹²

A common argument against the deposit of pre-appearance security is that trust funds are deposited with the relevant state and are sufficient to cover the reinsurance dispute. Further, requirements for pre-appearance security may contravene British common law,⁹³ and thus, with reference to litigation involving reinsurers in the U.K., could impair an otherwise enforceable judgment under the Convention.⁹⁴

There is also reference in the Convention to non-enforceability of personal injury and property damage claims, which would include asbestos-related claims.⁹⁵ Asbestos exposure is one of the major risks reinsured by alien reinsurers, especially Lloyd's.⁹⁶ If asbestos-related claims are excluded under the Convention, this could dilute any practical application of the Convention to disputes between and among insurers and reinsurers. Under the Convention this would not be exclusive to U.S. insurers vs. non-U.S. reinsurers. It could also prevent application between and among E.U. entities.

⁹² N.Y. Ins. Law §§ 1101(b)(2)(G), 1213 (c)(1)(A) (1985 & Supp. 1996).

⁹³ See, e.g., *Mubi v. Ardra Ins. Co.* (1997) (refusing to enforce a New York security award because, *inter alia*, award offended British and Bermudian notions of substantial or natural justice). See also Barry R. Ostrager & Mary Kay Vyskocil, *Modern Reinsurance Law and Practice*, § 13.02 Pre-Appearance Security Requirements (2^d ed., 2000).

⁹⁴ See *NAIC White Paper, supra*, at 35 ("[I]ndustry analysis of case law indicates that U.S. state insurance code requirements such as pre-answer security could render a judgment unenforceable under public policy exceptions in British Common Law and Swiss Law.")

⁹⁵ *NAIC White Paper, supra*, at 35-36. The Convention allows jurisdictions to declare that certain matters are not subject to the Convention as adopted in that jurisdiction. Matters dealing with asbestos ... have been of noted concern among particular countries during negotiation of the Convention. The language of the Convention addressing insurance does not provide a specific exception to the declaration provisions so the declarations provisions will likely take precedent over the insurance provisions and will allow a country to refuse enforcement of insurance and reinsurance obligations related to such matters.

⁹⁶ Presentation by Equitas CEO Scott Moser to the London Insurance Markets course, on location in London, The University of Connecticut School of Law, Insurance Law Center, Mar. 12, 2007.

An additional complication is the fact that the Convention only deals with private matters. “The Convention relates to private international law only and not public law matters.”⁹⁷ As state-mandated insurance reserves or trust funds are not private matters, it would appear disputes regarding reserves or trust funds would not be addressed under the Convention. In recognition of the private matter vs. public matter distinction under the Convention, the NAIC has commented that collateral requirements “are a fundamental part of state-based solvency regulation, (*i.e.*, not ‘private’ for purposes of the Convention) and as such they fall under the ‘prudential’ exception in the international trade rules.”⁹⁸

With all of these international law complexities, and despite the reform proposals of the NYSID, there is seemingly little chance that the demands of alien reinsurers for complete elimination of U.S. collateral requirements are going to be met, at least not anytime soon.

Comparison of U.S. and International Accounting Standards

U.S. insurance regulators are concerned about “the challenges in understanding the non-U.S. reinsurers’ finances given the lack of a single solvency framework – or even a single system of insurance accounting.”⁹⁹ The global reinsurance industry has not been able to agree on acceptable standards of prudential regulation or accounting methods. Some countries have nascent regulatory schemes, with little uniformity and transparency.

There is no mutual recognition (a) among the U.S. states and (b) among E.U. states concerning acceptable accounting standards. This must be achieved before there can be any meaningful discussion regarding mutual U.S.-E.U. recognition of the respective countries’ accounting practices.

There are two main accounting standards used in the U.S.: Generally Accepted Accounting Principles (“GAAP”) and Statutory Accounting Principles (“SAP”). The unique differences underscore the respective underlying philosophies of the two systems. GAAP is intended to fulfill the needs of various business users of financial statements (not regulators or policyholders), whereas SAP is intended to answer the concerns of regulators and policyholders. Consequently, GAAP emphasizes the measurement of emerging earnings, comparing quarter to quarter; whereas SAP stresses measurement of ability of a reinsurer to pay claims.

In the European Union, only the GAAP accounting standard is used. The rating agencies make reference to U.K. GAAP, E.U. GAAP and U.S. GAAP.¹⁰⁰ There is no reliance upon the SAP standard for insurance accounting. Thus, any contention that all countries and regulators are on the same page with respect to accounting methods and principles, is simply unrealistic.

2. Diversification Issue

Lloyd’s wants to be able to use assets currently tied up in trust funds in the U.S. for diversification. “It had long been argued by some that removing burdensome collateral requirements on foreign reinsurers in the United States will unlock capital that could be used to

⁹⁷ NAIC White Paper, *supra*, at 36.

⁹⁸ NAIC White Paper, *supra*, at 35-36.

⁹⁹ NAIC International Report, *supra*, note 61.

¹⁰⁰ See, e.g., Standard & Poor’s Rating of the Lloyd’s Market, Sept. 2007, available at <http://www.lloyds.com/NR/rdonlyres/59A74C5D-E7A8-4833-AE51-7EEA53F5AA66/0/SandPFALSeptember2006.pdf>.

provide more reinsurance and allow companies like Lloyd's to spread risk around the world. Diversify, that is.”¹⁰¹

The same argument can be made for unauthorized U.S. reinsurers that are required to post collateral, so this is not a uniquely foreign problem. The argument also skirts the protective purpose of the collateral requirements. As pointed out in the *NAIC Collateral White Paper*:

If collateral requirements were reduced for qualified professional reinsurers, what would these reinsurers do with those funds earmarked to pay claims for U.S. policyholders? One likely scenario of concern to regulators is that the reinsurers would leverage those funds in writing additional business globally, thus putting at risk precisely those monies ultimately owed to U.S. policyholders.¹⁰²

3. The Capacity Issue

The NYSID has recognized this lack of reinsurance capacity. According to New York State Insurance Superintendent Dinallo, "There is a growing need for reinsurance in ... New York to deal with risks from terrorism and from natural catastrophes such as hurricanes."¹⁰³

New York State's proposed reinsurance reforms are intended to increase capacity by relaxing collateral requirements. It is thus not clear that foreign reinsurers need to motivate U.S. regulators to budge on the collateral issue – it seems there is sufficient internal motivation in the U.S. to increase reinsurance capacity.

Not all agree that New York's proposed reforms would increase capacity. "*Nowhere has anybody ever shown that a reduction in collateral will ever increase capacity,*" said Mike Koziol, Assistant Vice President and Counsel for the Property Casualty Insurers Association of America.¹⁰⁴

4. The Pricing or Rate Reduction Issue

The more frustrated alien reinsurers become with what they see as little to no movement of the U.S. on its collateral requirements, the more they develop new arguments. The latest argument being debated in the insurance news circles is that collateral pushes up reinsurance pricing and rates. According to one reporter, "*The reinsurance collateral debate, until now, has been framed as a capacity issue, and hardly connected to pricing decisions.*"¹⁰⁵ "*What role, if any, collateral requirements play in setting reinsurance and insurance rates wasn't really part of the debate.*"¹⁰⁶

¹⁰¹ David Dankwa, *Insurers Disagree With New York View of Rate Reductions as Benefit of Collateral Reduction*, InsuranceNewsNet.com, available at http://www.insurancenewsnet.com/article.asp?neid=20071029200.1_4268002b953557cc.

¹⁰² *NAIC White Paper*, *supra*, at 27.

¹⁰³ *Level Playing Field*, *supra*, note 9.

¹⁰⁴ Roberto Ceniceros, *N.Y. to Ease Reinsurer Collateral Requirements*, *Business Insurance*, Oct. 22, 2007, available at <http://mobile.businessinsurance.com/palm/issuearticle.vmc?articlelink=cgi-bin/article.pl?>

¹⁰⁵ David Dankwa, *supra.*, note 73.

¹⁰⁶ *Id.*

The U.S. relies heavily on foreign reinsurance, including the London market. Alien reinsurers argue that collateral requirements force premiums for reinsurance to be higher than they otherwise would be, and that a reduction or elimination of collateral requirements would lead to greater availability of reinsurance to the world market, including, notably, the U.S.

E. Legacy Issues – Previous U.S. Distrust of European Insurance Regulation and the Rebuilding of Confidence

Some non-U.S. reinsurers argue that their regulatory schemes are as good as those in the U.S. Time will tell if this is true. For any observer of the London insurance market, it will take a long time for recovery from the failed Lloyd's of London, both in terms of new regulatory control by the nascent FSA, and the indelible scar on British pride. The industry will not quickly forget that a self-regulated Lloyd's of London failed to adequately reserve for "delayed manifestation asbestos, pollution and health (APH) claims," "predominantly arising from exposures in the U.S. market."¹⁰⁷ This was the same company that had to mortgage its own Central Fund, sell its building, and demand fresh capital infusion from its brokers and the Names to deal with unreserved losses.¹⁰⁸

Perhaps there is a little patriotism and politics, and not just economics, that goes along with sizing up competitors from foreign countries. This is certainly true of the British, as they struggled with whether to join the E.U. and become "European." The same may hold true for how Americans view Europeans in modern-day business transactions, and no doubt this somehow colors one's thinking when considering the collateral debate.

Lloyd's of London was a venerable institution, filled with mystery. Centuries old and thought to be as solid as the Rock of Gibraltar, it disappointed thousands when it fell to its knees and gasped its last breath. Its remaining assets and what could be collected from market participants were transferred to the legally independent Equitas for run-off. At the same time, the "new" Lloyds was surfacing and announcing self-regulatory reforms, including a "Franchise Performance Directorate."¹⁰⁹

A hard and even-handed look at the new Lloyd's reveals some truly redeeming changes – perhaps the most significant of which is the option to avoid unlimited liability. Even the Names have new options to convert to limited liability. Corporations are now eligible for membership and, of course, they have limited liability as the only option.¹¹⁰ To this extent, any argument that Lloyd's may be arrogant in demanding elimination of collateral in the U.S. when it demands collateral of its Names, is greatly diluted. The syndicates are still required to place trust funds into the Lloyd's Central Fund, but at least the individual members, the Names, no longer face personal bankruptcy in the event of a syndicate failure.

Lloyd's and the Rating Agencies

¹⁰⁷ As emphasized by Scott Moser of Equitas, *supra*, note 68.

¹⁰⁸ Presentation by Barrister David Tiplady of Beachcroft Wansbroughs, to the London Insurance Markets course, on location in London, U.K., The University of Connecticut School of Law, Insurance Law Center, March 16, 2007.

¹⁰⁹ Guy Carpenter, *The Lloyd's Market in 2004*, page 16, available at <http://www.guycarpenter.com>.

¹¹⁰ *Id.*, at 3. In 2004, the capital base of Lloyds had limited liability corporate vehicles supplying 87.5 percent of the market's capacity and unlimited liability names the remaining 12.5 percent.

The Lloyd's market and its syndicates have been rated by one or more of the rating agencies since October 1997. These agencies include A.M. Best, Fitch Ratings,¹¹¹ Moody's, and Standard & Poor ("S&P"). Moody's rates the syndicates, but not the market.

1. Lloyd's Market Ratings

The exposure of the various syndicates is partially mutualized through the vehicle of the Lloyd's Central Fund. The Lloyd's market ratings apply to all business written by all syndicates post 1992 - the year the long-tail exposures of Lloyd's of London, especially asbestos exposures, were reinsured into Equitas. "As a result of implementation of phase one of the Equitas agreement with National Insurance Company, Lloyd's exposure to uncertainty related to Equitas has been substantially reduced."¹¹² This led to A.M. Best's upgrading Lloyd's Financial Strength Rating ("FSR")¹¹³ from A-(Excellent) to A (Excellent) on July 19, 2007. All of the rating agencies that rate the Lloyd's market have given it high ratings.¹¹⁴

2. Lloyd's Syndicate Ratings

While market ratings are the principal measure of financial strength for those analyzing the strength of Lloyd's, the demand for syndicate-specific information has increased. S&P does not deem syndicate-specific financial strength ratings to be meaningful. It argues that the effective mutualization of all market risks through the Central Fund means that, for Lloyd's, the defaulting entity would be the market as a whole, rather than individual syndicates or their members.¹¹⁵ For those interested in differentiations among syndicates, not just in terms of pure credit quality, but also in terms of likely syndicate continuity, S&P started publishing Lloyd's Syndicate Assessments in September 2002. These are evaluations of the degree to which a syndicate is dependent upon Lloyd's Central Fund, brand, licenses, infrastructure and ultimately Lloyd's market's financial strength rating itself.

F. New York's Response to E.U. Criticism – Leveling the Playing Field

Past Accommodations

It is probably fair to say that New York insurance regulators have been accommodating alien reinsurers, at least Lloyd's, starting as early as the 1995 NYSID Audit of Lloyd's for the period ended December 31, 1993. This audit found an \$18.5 billion Lloyd's deficiency in required trust funds.¹¹⁶ There was also a shortfall in new cash infused into Lloyd's/Equitas in

¹¹¹ See Lloyd's Web Site, available at <http://www.lloyds.com/search/Search.aspx?q=Fitch>.

¹¹² See A.M. Best, 2007 Special Report: Lloyd's – 2006 Market Review, July 17, 2007, available at http://www3.ambest.com/bestweek/purchase.asp?record_code=134784&AltSrc=26.

¹¹³ "A Best's Financial Strength Rating is an independent opinion, based on a comprehensive quantitative and qualitative evaluation, of a company's balance sheet strength, operating performance and business profile." "A Best's Financial Strength Rating (FSR) is an opinion of an insurer's ability to meet its obligations to policyholders." See A.M. Best's website, available at <http://www.ambest.com/ratings/guide.asp>.

¹¹⁴ As of the last report for each agency, these ratings are A.M. Best A(Excellent), see A.M. Best's website, available at <http://www.ambest.com/ratings/guide.asp>; Fitch Ratings A+(Strong)(Upgrade Mar. 28, 2007), Stable Outlook, available at http://www.fitchratings.com/corporate/ratings/issuer_content.cfm?issr_id=80361962; S&P A+ (Strong), Stable Outlook, See S&P's Rating of the Lloyd's Market, Sept. 2006, available at <http://www.aecunderwriting.it/public/sandpfal.pdf>.

¹¹⁵ Guy Carpenter, *supra*, page 22.

¹¹⁶ See TruthAboutLloyds, *supra*, available at <http://www.truthaboutlloyds.com/regulation/nyidreport.html>.

September of 1996, required for Lloyd's of London's rehabilitation program known as Reconstruction & Renewal. In short, the NYSID did not demand immediate funding of accounts to make up the shortfall, but worked with Lloyd's in overcoming its problems.

The required degree of state regulation of insurance under the federal McCarran-Ferguson Act ("MFA") is not great. The relevant part of the Act was set forth on page 4 above. As stated earlier, the collateral debate does not involve tension between agencies and courts. There are no federal *vs.* state debates in a legal sense (only in the sense of a possible federal regulation in the possible OFC context).¹¹⁷ Since there are no acts of Congress challenging whether New York's arguably lax oversight of the trust funds, which allowed the shortfall in required trusteed funds, there have been no discussions about that audit in the context of MFA.

Current Accommodations of the E.U. – Proposed Reform to Collateral Requirements Leveling the Playing Field Sans OFC

The Superintendent of Insurance for the NYSID has announced proposed new reinsurance collateral rules.¹¹⁸ Alien and domestic unauthorized reinsurance companies with the highest credit ratings will be treated the same as authorized companies. Weaker reinsurance companies will be required to post collateral on a sliding scale from 10 to 100 percent. Unauthorized reinsurers with a triple A credit rating from two rating agencies would not have to post collateral. Unauthorized reinsurers with a double A or equivalent rating would have to post collateral equal to 10 percent of claims, single A 20 percent, and triple B 50 percent. Unauthorized reinsurers having a credit rating below triple B would still be required to post 100 percent collateral.

Other requirements would be as follows:

An unauthorized reinsurer must:

Meet the standards of solvency, including standards for capital adequacy, established by its domestic regulator;

Be authorized in its domiciliary jurisdiction to assume the specific kind of reinsurance it is offering;

See also Aliens Forces At Work, supra, note 66. "For 2004, reinsurers had posted about \$98 billion in collateral, with about \$88 billion coming from reinsurers outside the United States and the remaining \$10 billion coming from U.S. reinsurers operating in states where they aren't licensed, according to the RAA."

¹¹⁷ For an analysis of reinsurance collateral at the intersection of the World Trade Organization ("WTO") General Agreement On Trade In Services ("GATS"), and the U.S. Constitution, see Gregory S. Arnold, *Reinsurance Collateral At The Intersection of International Law and The U.S. Constitution*, available online at http://works.bepress.com/gregory_arnold/. For a lighthearted look at the "red herrings" and "elephants in the room" connected with this debate, see Gregory S. Arnold, Slide Presentation, *Reinsurance Collateral At The Intersection of International Law and the U.S. Constitution*, PowerPoint Presentation (hereinafter "Reinsurance Collateral Presentation"), slides 7 thru 16, available online at http://works.bepress.com/gregory_arnold/14.

¹¹⁸ *See Level Playing Field, supra note 9. Removed from the list for purposes of this article is the following language: "and considers such matters as regulatory equivalency and enforceability of judgments", following the words "Have a primary regulator that has a memorandum of understanding with the NYSID that addresses information sharing". This is because "there is some legal debate whether states can compel a foreign regulator to take or require specific legal actions against a company domiciled there." See New York Set to Relax Reinsurer Collateral, Meg Fletcher, Business Journal, July 7, 2008, available at <http://www.businessinsurance.com/cgi-bin/article.pl?articleId=25319>, last viewed October 6, 2008.*

Maintain a policyholder's surplus or equivalent in excess of \$250,000,000;

Accept required contract terms, including consent to the jurisdiction of U.S. courts for disputes;

Have a primary regulator that has a memorandum of understanding with the NYSID that addresses information sharing;

Be domiciled in a country that allows U.S. reinsurers access to its market on similar terms; and

Post 100 percent collateral upon the entry of an order of rehabilitation, liquidation or conservation against the ceding insurance company.

Collateral requirements will not change for authorized reinsurers¹¹⁹; they will still not be required to post any collateral. However, new safeguards will be put in place to help ensure the ability of these reinsurers to cover claims and thus protect consumers.

Insurance companies ceding risk to reinsurers have responsibility for vetting those reinsurers and developing risk management plans for their reinsurance placements.

The Superintendent of Insurance will retain final authority over any particular transaction.¹²⁰

The new collateral regulation was subjected to a comment period and, as of July 2008, was still undergoing the vetting process.

Meanwhile, the E.U.'s Reinsurance Directive still has not been enacted into law. The Reinsurance Directive will require complete elimination of collateral among E.U. Member States, while New York's proposed reform, while very encompassing, falls short of that. The New York proposed reforms come at a time when New York has also announced its principles-based insurance regulation reform initiatives.

As recently as November 2007, NYSID took the lead in the United States as the first insurance department to endorse European-like¹²¹ principles-based insurance regulations, some of which are identical to those unveiled by the U.K.'s FSA earlier this year.¹²² See Table 1 for a striking, side-by-side comparison of the language of the respective insurance regulation schemes.

"Principles-based regulation requires aligning regulatory compliance with business goals while protecting consumers," Dinallo said. "The goal here is an effective, efficient reinsurance industry that will maximize the capital available to insurers and help insurers meet consumer

¹¹⁹ W.R. Berkley Corporation is the only remaining domestic, authorized reinsurer of any size.

¹²⁰ As reported in *Level Playing Field*, *supra* note 9.

¹²¹ The news articles about NYSID's principles-based insurance regulations are silent as to the particular author of the proposed reforms, with an inference they are the idea and creation of Insurance Superintendent Dinallo. The fact that the FSA published a document with substantially similar, and in some cases, identical wording, with the exception of "must" FSA and "shall" NYSID, strongly suggests the NYSID "borrowed" the idea and language from the FSA.

¹²² *N.Y. Insurance Department Advances First Principles-Based Regulation*, Insurance Journal, Nov. 5, 2007, available at <http://www.insurancejournal.com/news/east/2007/11/05/84761.htm>.

needs."¹²³ Dinallo refers to “business-to-business transactions” where New York is moving to let the market decide. According to Dinallo, “[t]his risk-focused approach means principles-based regulation is being applied to all reinsurers”¹²⁴

New York State’s proposed relaxation of reinsurance collateral requirements for unauthorized reinsurers is the first major accommodation of alien reinsurers to date. With the exception of Florida¹²⁵, the other U.S. insurance regulators have thus far not embraced widespread changes in the requirements for posting of collateral related to reinsurance transactions with unauthorized reinsurers, either domestic or international. With New York and Florida demonstrating strong leadership, other states are sure to follow.

III.

European Interest in an Optional Federal Charter in the U.S.

European reinsurers are hopeful that the U.S. will adopt a federal charter system of regulating insurance. This appears to flow, at least in part, from an unfounded assumption that a federal charter would in and of itself beget suppression or elimination of reinsurance collateral requirements. The single passport to Europe, however, is not necessarily tied to suppression of collateral requirements in the E.U., and there is no reason to assume that an OFC would necessarily lead to suppression or elimination of collateral requirements in the U.S. The U.S. is not confronted with the same common market or economic integration issues facing the E.U. An analysis of the proposed OFC and a review of legal history and treatment of insurance in the U.S. dispels any notion that an OFC would have the results desired by the E.U.

The NYSID has recently proposed reinsurance regulatory reform that would significantly relax, and in some cases eliminate, unauthorized reinsurer collateral requirements. This would be based upon a proposed system of credit rating. This proposed reform comes at a time when there has been no announcement of a projected date when an OFC might possibly be a reality, if ever.

Whether an OFC will ever be a reality, and the question whether an OFC is a predicate to reform of collateral requirements, are two separate studies. For the legal historian, and by way of review, it should be emphasized that Congress has never wanted to regulate the business of insurance. The prospect of federal regulation of insurance was anathema to Congress, so much so that the U.S. Supreme Court, starting with *Paul v. Virginia*,¹²⁶ and continuing through a curious progeny of cases leading up to *Southeastern Underwriters*,¹²⁷ advanced the fiction¹²⁸ that insurance is not commerce.

¹²³ *Level Playing Field*, *supra* note 9.

¹²⁴ *Id.*

¹²⁵ See the November 11, 2007 draft of Florida rule 690-144.007 Ratings Based Collateral Requirements, Available at <http://www.flair.com/pdf/ReinsuranceCollateralRule.pdf>, last viewed October 14, 2008.

¹²⁶ *Paul v. Virginia*, *supra*, note 5. For historical perspective, it is interesting to note that The first insurance company was established in the United States on February 3, 1736, in Charles Town (now Charleston), South Carolina. This was The Friendly Society for the Mutual Insurance of Houses Against Fire.¹²⁶ This was followed in March 1752 with The Philadelphia Contributionship for the Insurance of House from Loss by Fire, which was organized by Benjamin Franklin and his colleagues. The “Philadelphia Contributionship” nicknamed the “Hand-in-Hand,” remains today as the oldest mutual fire insurance company in business in America.

¹²⁷ *Southeastern Underwriters*, *supra*, note 3.

In *Paul*, the U.S. Supreme Court held that “[t]he issuing of a policy of insurance is not a transaction of commerce ... even though the parties be domiciled in different States, but is a simple contract of indemnity against loss,”¹²⁹ thus effectively, but only temporarily, establishing case law removing the business of insurance beyond the legislative reach of Congress.

With respect to the fiction theory, the *Paul* court was not presented with any facts concerning international insurance or (re)insurance, or the business of “ceding” or “accepting” versus “issuing” of (re)insurance. *Paul* does not contain a single reference to “reinsurance,” but a careful review of the case leads to the conclusion that such lack of reference to reinsurance is of no consequence. The Court did seriously consider other instruments of commerce, and it appears that, had the court specifically considered international aspects of (re)insurance, it would have come to the same conclusion, i.e., “The issuing of a policy of insurance is not a transaction of commerce ...,” and the fiction referenced by Justice Jackson would have still been advanced.

Paul was overruled in *United States v. Southeastern Underwriters Assn.*¹³⁰ From a review of the dissents by Justices Jackson and Stone in that case, it is clear they shared the opinion that the *Paul* majority continued to advance the fiction that insurance was not commerce, because Congress did not want to occupy the field of insurance. Justice Stone agonized over how the majority opinion would simply result in forcing the hand of Congress to take action it did not want to take.¹³¹ With the enactment of the MFA, Congress acted, but has effectively stayed its hand by leaving the regulation of the business of insurance to the states.

IV.

Reinsurance Collateral As A Fair Trade Issue

A. The World Trade Organization (“WTO”) General Agreement in Trade Services (“GATS”)

The General Agreement on Trade in Services (GATS) is a multilateral variety of treaty that is part of the many international agreements of the WTO. GATS went into force in January 1995 so as to extend the multilateral trading system to the financial services sector, in the same manner that the General Agreement on Tariffs and Trade (GATT) provides such a system for the sale of goods. All acceding members of the WTO are acceding signatories to GATS.

GATS was enacted in recognition of “...the growing importance of trade in services for the growth and development of the world economy”¹³² and with the wish “...to establish a

¹²⁸ See the dissent of Justice Jackson in *Southeastern Underwriters*, page 1190, “In contemplation of law, however, insurance has acquired an established doctrinal status not based on present-day facts. For constitutional purposes a fiction has been established, and long acted upon by the Court, the states, and the Congress, that insurance is not commerce.”

¹²⁹ *Paul*, at page 3.

¹³⁰ *Southeastern Underwriters*, *supra* note 6.

¹³¹ Justice Stone’s preference, as stated in his dissenting opinion, would have been to ignore the issue of whether insurance is commerce, and simply allow the Sherman Act to control insurance companies in the same way it would control other commercial endeavors. Current reform proposals would have that same effect. One reform proposal is to allow MFA to exist, but without the anti-trust exemptions. As presently worded, there are no anti-trust exemptions for boycott, intimidation, or coercion by insurance companies.

¹³² See GATS, Annex B, Preamble preceding Part 1, Scope and Definitions.

multilateral framework of principles and rules for trade in services with a view to the expansion of such trade under conditions of transparency and progressive liberalization and as a means of promoting the economic growth of all trading partners and the development of developing countries;...”¹³³.

Two provisions of GATS are central to the analysis of whether there is a violation of this treaty in the context of the CFRML § 3 requirement that non-U.S. reinsurers post reinsurance collateral. These are Article II, Most-Favoured-Nation Treatment under Part II, General Obligations and Disciplines. The other is Article XVII, National Treatment, under Part III, Specific Commitments. The intent of this analysis is to isolate the existing reinsurance collateral requirements under CFRML § 3 and to examine those requirements in a discreet fashion, separate and apart from recent regulatory reform proposals of the NAIC and some states.

(a) Most-Favoured-Nation Treatment

The relevant text of the GATS treaty, Part II “General Obligations and Disciplines”, Article II, Paragraphs 1 and 2, reads as follows:

- 1. With respect to any measure covered by this Agreement, each Member shall accord immediately and unconditionally to services and service suppliers of any other Member treatment no less favourable than that it accords to like services and service suppliers of any other country.*
- 2. A Member may maintain a measure inconsistent with paragraph 1 provided that such a measure is listed in, and meets the conditions of, the Annex of Article II Exemptions.*

With respect to paragraph 1 above, the natural inquiry to be made is whether CFRML § 3 is in violation of GATS for failure of the U.S., a Member of GATS, to “*accord immediately and unconditionally to (reinsurance) services and service suppliers (non-U.S., unlicensed reinsurers) of any other Member (regulators/countries of domicile of non-U.S., unlicensed reinsurers) treatment no less favourable than that it accords to like (reinsurance) services and service suppliers (domestic reinsurers, both licensed and unlicensed) of any other country.*” It is important to note that CFRML § 3 does not differentiate or discriminate among non-U.S., unlicensed reinsurers with its descriptor “alien assuming reinsurers”. There is no provision that makes an exception for, say, Australia, from the requirement to post collateral, while requiring that collateral be posted by reinsurers or reinsurance markets in, say, the United Kingdom¹³⁴

Furthermore, there is no GATS provision that “*any other country*” includes the country interpreting the treaty in light of its own treatment of other members. In other words, the U.S. need not include itself in this analysis and make the analysis whether the U.S. is the Most-Favoured-Nation of itself. *Ergo*, a direct examination of what the U.S. requires of reinsurance regulators in other countries *vis-à-vis* what the U.S. requires of reinsurance regulators within its own borders, is neither contemplated nor required by GATS.

¹³³ *Ibid*, same location.

¹³⁴ Australia and the United Kingdom became members of the WTO on January 1, 2005. See the web site of the World Trade Organization: Members, *available* online at http://www.wto.org/english/thewto_e/whatis_e/tif_e/org6_e.htm, last visited Dec. 8, 2009.

An analysis of the safe harbor provision of Paragraph 2 would require a fictional assumption that CFRML § 3 does differentiate, or discriminate among, non-U.S., unlicensed reinsurers. For the sake of academic examination, let us assume the U.S. provides Most-Favoured-Nation Treatment to Belgium, but not France¹³⁵. May the U.S. “maintain a measure inconsistent with paragraph 1”? Such a measure would need to be listed in, and meet the conditions of, the Annex on Article II Exemptions.

The scope of the Annex on Article II Exemptions is found in paragraph 1, and reads as follows:

This Annex specifies the conditions under which a Member, at the entry into force of this Agreement, is exempted from its obligations under paragraph 1 of Article II.

Under “List of Article II Exemptions” is the “Annex on Financial Services”. Under paragraph 2(a), “Domestic Regulation”, appears the following very important exemption language:

Notwithstanding any other provisions of the Agreement, a Member shall not be prevented from taking measures for prudential reasons, including for the protection of investors, depositors, policy holders or persons to whom a fiduciary duty is owed by a financial services supplier, or to ensure the integrity and stability of the financial system. Where such measures do not conform with the provisions of the Agreement, they shall not be used as a means of avoiding the Member’s commitments or obligations under the Agreement.

“For Purposes of this Annex”, financial service is defined as follows:

5(a) A financial service is any service of a financial nature offered by a financial service supplier of a Member. Financial services include all insurance and insurance-related services, and all banking and other financial services (excluding insurance). Financial services include the following activities:

(ii) Reinsurance and retrocession;

“[T]he WTO legal framework for financial services addresses the intersection between financial services liberalization commitments and the role of prudential regulation”.¹³⁶ The word “prudential” is mentioned four times, but not defined anywhere in GATS. Various definitions from dictionaries include “exercising shrewdness”, “caution”, “skill”; “good judgment in the management of business matters”; and “prudence.” The word “prudential” is often followed with the word “solvency”.

1. The Prudential Carve-Out Exception

¹³⁵ Belgium and France became members of the WTO on January 1, 2005. *Ibid.*

¹³⁶ Douglas W. Arner, *Financial Stability, Economic Growth, and the Role of Law* (hereinafter simply “Financial Stability”), Cambridge University Press (June 4, 2007), at 273.

Legal scholars and authorities such as Dr. Sydney J. Key, refer to “a ‘prudential carve-out’ exception for domestic regulation that is designed to ensure that the obligations or commitments a country has undertaken in the GATS will not interfere with the ability of the national authorities to exercise their responsibilities for prudential regulation and supervision.”¹³⁷ According to Dr. Key, “[t]his provision was included in the GATS at the insistence of financial regulators, who made it clear that the inclusion of financial services in a multilateral trade agreement such as the GATS would be unacceptable without a specific carve-out from the obligations of the agreement for prudential measures.”¹³⁸

Author Douglas W. Arner has given a lot of thought to the prudential carve-out, and provides a succinct summary, as follows:

The scope of the prudential carve-out depends upon the distance between prudential measures and GATS obligations: the longer the distance, the broader the scope of the carve-out, and vice versa. To identify the scope of the prudential carve-out is, in essence, to identify the distance of GATS obligations and prudential measures, to strike a balance between the two. Para. 2(a) does not define the concept of prudential carve-out, or clearly identify the distance between the carve-out and GATS obligations, so there is much room for members to maneuver.

Thus, based upon the reasoning of Arner, there is ample room to argue that U.S. reinsurance collateral requirements are not a violation of GATS. This is confirmed by the Chief Insurance Examiner of the New Jersey Department of Banking and Insurance, Robert B. Kasinow, as follows:

“Collateral requirements equal fundamental state based solvency regulation, so are under “prudential” carve out in international trade rules.” “Under international treaties the NAIC, states and U.S. government are not compelled to engage in trade negotiations over these issues.” “The WTO does not have jurisdiction over state regulatory authorities, nor does the WTO tell governments how to conduct their trade policies.”¹³⁹

This is consistent with the official position of the NAIC, which has stated that reinsurance collateral requirements “are a fundamental part of state-based solvency regulation...and as such they fall under the ‘prudential’ exception in the international trade rules.”¹⁴⁰ Recall the purpose statement, § 1 of the CFRML, set forth on page 5 of this paper, i.e., “The legislature declares that the matters contained in this Act are fundamental to the business of insurance in accordance with 15 U.S.C. §§ 1011-1012.”

¹³⁷ Testimony of Dr. Sydney J. Key, Former Staff Director of the Subcommittee, “Increasing Efficiency and Economic Growth Through Trade in Financial Services”, Before the Subcommittee on Domestic and International Monetary Policy, Trade and Technology, Committee on Financial Services, U.S. House of Representatives, November 15, 2005. Available online at <http://financialservices.house.gov/media/pdf/111505sk.pdf>.

¹³⁸ See Key, “Trade Liberalization”, *supra*, pp. 61-75. A prudential carve-out is also included in NAFTA. See Key, *Id.*, at 67.

¹³⁹ Robert B. Kasinow, Chief Insurance Examiner, New Jersey Department of Banking and Insurance, Slide Presentation on *Reinsurance Regulatory Modernization*, Financial Summit, 2008 Leadership Initiatives, undated, page 13, slide one of four, Available online at http://www.naic.org/documents/frs_summit_presentations_29.pdf, last viewed Dec. 10, 2008.

¹⁴⁰ NAIC *White Paper*, *supra*, at pp. 35-36.

Addressing the issue squarely, The Chief Insurance Examiner for the New Jersey Department of Banking and Insurance has stated that “[t]he prudential carve-out has also been cited in the past as permitting the NAIC’s 100% collateral requirements for non-U.S. reinsurers under Section 3 of the Credit for Reinsurance Model Law.”¹⁴¹

Even if the reinsurance collateral requirements under CFRML, § 3 somehow were a technical violation of the MFN obligations, for example, under the disparate treatment hypothetical given above, the distance between the prudential measures (reinsurance collateral requirements) and GATS obligations (MFN and National Treatment commitments), discussed later in this article, there are justifications for such disparate treatment, justifiable under the rubric of prudential measures.

These justifications for disparate treatment include, *inter alia*, (1) the identification of meaningful differences or lack of functional equivalency of reinsurance regulatory schemes in other countries, and (2) the difficulty in enforcement of U.S. judgments in distant foreign courts or executing against assets located outside of the U.S. “U.S. claimants should not be required to resort to the often insuperable obstacle of resorting to distant forums for the purpose of asserting legal rights or claims on contracts issued to U.S. residents and subject to U.S. laws.”¹⁴²

“The prudential carve-out allows states to impose regulatory barriers to trade in financial services if such measures are adopted for ‘prudential reasons’ or to ‘ensure the integrity and stability of the financial system.’¹⁴³ Under the prudential carve-out, “...all prudential measures are excepted. As a result, a prudential measure may not be challenged on the ground that it is not ‘necessary’ or ‘least trade restrictive’. Moreover, the prudential carve-out overrides the GATS requirements for domestic regulations.”¹⁴⁴

The issue of enforcement of judgments is an open sore for some critics of the U.S. reinsurance collateral requirements. Spokesmen for Lloyd’s have referred to this as one of the “red herrings” advanced by the U.S. in the collateral debate.¹⁴⁵ The “red herring” metaphor may be no more persuasive than “the elephant in the room” simplicity of non-U.S. reinsurers getting licensed in the U.S., so as to avoid the reinsurance collateral requirements altogether.

¹⁴¹ A letter to Gregory S. Arnold from Robert B. Kasinow, Chief Insurance Examiner, New Jersey Department of Banking and Insurance, November 5, 2008 (hereinafter simply “Kasinow November 5, 2008 letter”), on file with author.

¹⁴² After the model had been adopted by the drafters and forwarded to the Executive Committee for consideration, an interested party suggested that the new Section 1 might not be entirely appropriate for the purpose intended. She said the original objective had been to introduce new language to clarify the legislative intent underlying the credit for reinsurance statute as respects the collateral required to secure the obligations of alien reinsurers operating in the United States on the basis of multiple beneficiary trust funds, as provided in Section 2D of the model law. She indicated that at a recent hearing objections had been raised to the use of “inflammatory references.” The working group decided to eliminate the third sentence which read: “It is intended that U.S. claimants should not be required to resort to the often insuperable obstacle of resorting to distant forums for the purpose of asserting legal rights or claims on contracts issued to U.S. residents and subject to U.S. laws.” 1996 Proc. 2nd Quarter 864.

¹⁴³ Ken Alexander, Rahul Dhumale, John Eatwell, *Global Governance of Financial Systems: The International Regulation of Systemic Risk*, Oxford University Press US, 2006, at 108.

¹⁴⁴ See Key, *supra*, at 2.

¹⁴⁵ See The US Reinsurance Collateral Debate: the Latest “Red Herring”, November 6, 2007, Lloyd’s News, available online at http://www.lloyds.com/News_Centre/Features_from_Lloyds/The_US_Reinsurance_Collateral_Debate_the_latest_red_herring_061107.htm, last viewed Dec. 10, 2008.

All such arguments aside, the U.S. has real concerns when it comes to enforcement of judgments by domestic cedants against non-U.S. reinsurers and their assets located outside of the U.S. Even if a foreign regulatory regime were to be deemed “effective” because it may arrive at the same or nearly the same regulatory outcomes through different or “not like” means, and to the extent the U.S. might hypothetically impose different collateral requirements among various GATS Member countries, such disparate treatment, according to Kasinow:¹⁴⁶

[M]ay also be justified by differences in the enforceability of judgments obtained against non-U.S. reinsurers versus those obtained against U.S. reinsurers. It may be possible to show, for example, that neither U.S. regulatory regimes nor their functionally equivalent foreign counterparts eliminate all risk of default by reinsurers. If so, and if it can be demonstrated that, notwithstanding a finding of regulatory effectiveness, it is more difficult to satisfy judgments against non-U.S. reinsurers who assets are in a non-U.S. jurisdiction, this could also justify disparate collateral requirements under the prudential carve out.

(b) Other Obligations and Commitments Under GATS

Other GATS provisions worthy of consideration are the National Treatment Commitments, Recognitions, and GATS Commitment Withdrawal Restrictions¹⁴⁷.

B. U.S. Constitutional Law Issues

Efforts by the States to enter into compacts or other agreements with foreign governments, preparatory to relaxation or elimination of the reinsurance collateral requirements imposed upon unauthorized reinsurers by the various States, has sparked other debates as to whether such efforts might violate of the U.S. Constitution. Constitutional experts have examined whether these efforts are violations of the Compact Clause and the Federal Commerce Clause.¹⁴⁸

V.

Conclusion

The Europeans have had a unique experience with respect to pending elimination of reinsurance collateral requirements among the E.U. Member States. The Reinsurance Directive has yet to be implemented into national law by the respective E.U. member states, and three

¹⁴⁶ See “Kasinow November 5, 2008 letter”, *supra* note 30.

¹⁴⁷ For a discussion of these other aspects of GATS, plus a comparative regulatory analysis, including practical realities that would be expected to forestall any effective challenges to the U.S. practices, see Gregory S. Arnold, *Reinsurance Collateral At The Intersection of International Law and the U.S. Constitution*, available online at http://works.bepress.com/gregory_arnold/14, last viewed March 10, 2009.

¹⁴⁸ For an excellent analysis of the U.S. Constitutional law issues, see “NAIC Reinsurance Regulatory Modernization Framework Proposal”, July 15, 2008, NAIC Memorandum, available online at http://www.naic.org/documents/committees_e_reinsurance_memo_modernization_framework.pdf, last viewed December 10, 2008. See also Arnold, *Reinsurance Collateral*, *supra* note 4, at 28-33 (briefly discussing the Compact Clause, Art. 1, § 10, cl. 3; the Doctrine of Dormant Foreign Affairs Preemption; and the Dormant Federal Foreign Commerce Clause, Article 1, § 8).

member states still impose reinsurance collateral requirements on reinsurers in other E.U. Member States.¹⁴⁹

The E.U. experience has been one motivated not so much by the usual regulatory interests in solvency and consumer protection, but by Continental economics and a desire to become commercially competitive with third-country reinsurers. The E.U. interest in abolition of collateral in the U.S. has nothing to do with integration of the U.S. or world reinsurance markets, and has everything to do with feeling discriminated against and wanting to be better able to compete in the U.S.

There is no evidence to support the notion that federal regulation of insurance in the U.S. would of itself lead to any different results with respect to the credit for reinsurance laws that require collateral from unauthorized reinsurers. The NYSID is already setting the groundwork for regulatory reform, which will lead to relaxation of collateral requirements for unauthorized reinsurers. This is proof that there is no necessary nexus or overlap in these two areas.

Congress has historically shown no interest in occupying the field of insurance regulation, resisting every early opportunity presented to it to change its course on this issue. This was made clear by Justices Jackson and Stone in the *Southeastern Underwriters* case and Congress' immediate enactment of the MFA to ensure the states would continue regulating the business of insurance. Neither *Paul* nor the MFA exclude the federal government from regulating insurance. *Paul* simply held that a state regulatory statute did not interfere with interstate commerce, and the MFA actually contemplates that the federal government may pass laws dealing with insurance so long as Congress specifically mentions insurance in the body of the statute. The proposed National Insurance Act of 2007 stalled in Committee and there is no assurance that the anticipated 2009 version, the National Insurance Consumer Protection and Regulatory Modernization Act, will fair any better.

The NAIC has been proactive in responding to criticisms against the system of state regulation, and all indications are that it is willing to accept the role of a *de facto* "nationwide" regulator, addressing collateral and other issues as effectively as a *de jure* federal regulator would, while at the same time maintaining the current system of state regulation of insurance. The various bills introduced to create an optional federal charter give no clear indication reinsurance collateral would not be part of the regulatory framework. Any relaxation or elimination of collateral requirements will most likely be the result of the reform efforts of New York, Florida, and the other states that are sure to follow.

¹⁴⁹ *The US Reinsurance Collateral Debate: The Latest 'Red herring'*, Nov. 6, 2007, Lloyd's web site, available at http://www.lloyds.com/News_Centre/Features_from_Lloyds/The_US_Reinsurance_Collateral_Debate_the_latest_red_herring_061107.htm, last viewed March 10, 2009.