Direct Your Learning

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Reinsurance Regulation

Educational Objectives

After learning the content of this assignment, you should be able to:

- Explain how the following aspects of state insurance regulation apply to reinsurers:
  - Licensing
  - Rates and forms
  - Financial and market conduct oversight
- Explain how each of the following regulatory tools developed by the National Association of Insurance Commissioners (NAIC) is used by state insurance regulators as part of a comprehensive state-based national system of insurance regulation to monitor insurer solvency:
  - NAIC Annual Statement
  - NAIC Model Laws and Guidelines
  - NAIC Accreditation Program
  - Off-Site Monitoring and Analysis
  - On-Site, Risk-Focused Examinations
  - Insurance Regulatory Information System (IRIS)
  - NAIC Risk-Based Capital (RBC) System
- Describe the concerns of and actions taken by insurance regulators around each of the following:
  - Credit for a reinsurance transaction
  - Creditworthiness of reinsurers
  - Creditworthiness of reinsurance intermediaries
  - Contract certainty

Outline

Reinsurance Regulation

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STATE INSURANCE REGULATION AND REINSURERS

Reinsurers are subject to many of the same regulations as primary insurers. This discussion focuses on aspects of insurance regulation that are particularly applicable to reinsurers.

In the United States, primary insurers and reinsurers are predominately regulated at the state level. State legislatures enact laws providing the regulatory framework for primary insurers and reinsurers. State insurance departments enforce state insurance laws and create and enforce regulations.

A fundamental purpose of these laws and regulations is to protect consumers; they do this, in part, by helping to ensure insurer solvency so that contractual commitments to insureds and claimants can be met. Another regulatory goal is to promote a fair and competitive marketplace. As such, the laws and regulations grant broad authority to state insurance departments so that the complexity and variety of insurance issues can be addressed.

It can be challenging for states to regulate reinsurers that are incorporated in a different state or country. However, insolvency remains a key concern. If a reinsurer fails to honor a primary insurer's claims, the reinsurer could financially impair or cause the eventual insolvency of that primary insurer.

State insurance regulators work with one another through the **National Association of Insurance Commissioners (NAIC)** to identify reinsurers that are struggling financially. Ultimately, the responsibility for regulating reinsurer solvency rests with the reinsurer's state or country of domicile. However, if any state finds a reinsurer's solvency to be in jeopardy, it can suspend or revoke the reinsurer's license to operate in the state or classify the reinsurer as unauthorized.

National Association of Insurance Commissioners (NAIC)
An association of insurance commissioners from the fifty U.S. states, the District of Columbia, and the five U.S. territories and possessions, whose purpose is to coordinate insurance regulation activities among the various state insurance departments.

State insurance regulators regulate these aspects of insurers:

- Licensing
- Rates and forms
- Financial and market conduct oversight

Although reinsurers continue to be regulated in the U.S. at the state level, a number of developments in recent years have changed the regulatory landscape to some degree.

Licensing

Most insurers are licensed or authorized to sell insurance in one or more states. An insurer may be licensed as an authorized, or admitted, insurer with a license that stipulates which types of insurance it is permitted to sell. From a state regulator's perspective, an insurer is considered to be a domestic insurer if it has selected the state as its principal place of business and obtained a license from that state. The state will consider the insurer to be a foreign insurer if it is licensed as a domestic insurer in another state and to be an alien insurer if it is licensed in another country but permitted to write business in the state under certain circumstances.

A fundamental requirement for obtaining an insurance license is having adequate financial strength through policyholders' surplus and, in the case of a stock insurer, capital. Each state determines the minimum amount of capital and policyholders' surplus that an insurer must have to be licensed in the state; this amount not only varies by state, but by the type of insurance that the insurer wants to sell. If an insurer fails to meet the financial requirements, or fails to operate consistently with state insurance laws, state regulators can revoke or suspend the insurer's license.

A reinsurer that is authorized to do business in the primary insurer's state of domicile is called an authorized reinsurer. Authorized reinsurers include licensed reinsurers and reinsurers otherwise accredited to do business in the state (or licensed in a state with similar laws).An accredited reinsurer is an insurer that is otherwise unauthorized to do business in the same state as the primary insurer but is granted approval to assume reinsurance by meeting the state insurance department's requirements. Such requirements usually involve these actions:

- Filing a formal acknowledgment of the state's jurisdiction
- Submitting to financial examinations by the state
- Providing evidence that the reinsurer is licensed as an insurer or reinsurer in at least one other state, or, in the case of an alien reinsurer, is lawfully entered through another state
- Meeting specific policyholders' surplus requirements
- Filing annual financial statements

An unauthorized reinsurer is a reinsurer that is not licensed or otherwise authorized to do business in the primary insurer's state of domicile. Unauthorized reinsurers are usually alien reinsurers doing business in the U.S.

A certified reinsurer is a reinsurer that has been evaluated, rated, and approved by the primary insurer's domestic state for the purpose of reinsurance collateral reduction.For a U.S. primary insurer to be allowed credit for reinsurance ceded, a certified reinsurer must post collateral in an amount that corresponds with the rating assigned by the primary insurer's domestic state.

A reinsurer's authorization status is critical to the primary insurer. This status determines the conditions required for a transaction to qualify for favorable accounting treatment as a reinsurance transaction in the primary insurer's financial statements.

A reinsurance agreement with an authorized reinsurer benefits the primary insurer's financial results because it transfers financial obligations (liabilities for unearned premium reserves and loss reserves) from the primary insurer to the reinsurer, thereby increasing the primary insurer's policyholders' surplus. Additionally, the primary insurer can treat amounts owed by the reinsurer—usually loss payments—as assets.

A reinsurance agreement with an unauthorized or a certified reinsurer does not necessarily provide a primary insurer with the accounting benefit that a transaction with an authorized reinsurer provides. Specifically, a primary insurer may not take credit for reinsurance ceded to the reinsurer unless the financial obligations are appropriately collateralized by the unauthorized or certified reinsurer.

Because many primary insurers write some reinsurance and most reinsurers write some primary insurance, the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act) helps to define what constitutes a reinsurer. The act offers that the term "reinsurer" means an insurer to the extent that the insurer is principally engaged in the business of reinsurance, does not conduct significant amounts of direct insurance as a percentage of its net premiums, and is not engaged in an ongoing basis in the business of soliciting direct insurance. If there is a dispute about whether an insurer is classified as a primary insurer or a reinsurer, the laws of the state of domicile apply in resolving the dispute.

Rates and Forms

State insurance regulators have authority over many of the rates charged by authorized primary insurers. Likewise, state regulators must approve policy forms used by authorized primary insurers. State insurance regulators have authority over many of the rates charged by authorized primary insurers. Likewise, state regulators must approve policy forms used by authorized primary insurers. Such policy forms define financial obligations that the primary insurers have assumed from insureds. The rates provide the financial basis that primary insurers use to pay covered losses, while premium collected from policyholders is the consideration provided to validate the insurance contract.

Reinsurance rates are not subject to the filing and approval regulations applicable to most primary insurance rates. However, this does not mean that reinsurance rates are not affected by state insurance regulation. Rate regulation of primary insurers indirectly affects any subsequent reinsurance transaction. Inadequate primary insurance rates usually result in inadequate reinsurance premiums. When reinsurers are unable to obtain an adequate premium for the underlying loss exposure, they must restrict coverage, reduce ceding commissions, or decline coverage. Consequently, rate regulation of primary insurers can affect the availability of reinsurance in the marketplace.

State insurance regulators do not require the same prior approval or informational filings for reinsurance treaties and facultative certificates as they often do for primary policy forms. Instead, regulators influence the content of reinsurance agreements by requiring that they contain specific clauses. Most states require these clauses in reinsurance agreements with primary insurers:

- Insolvency clause—states that the reinsurer is not relieved of its responsibility under the reinsurance agreement should the primary insurer become insolvent
- Service of suit clause—requires an alien reinsurer to have an agent within the U.S. who can accept the formal delivery of writs, summonses, or other legal notices on the reinsurer's behalf
- Intermediary clause—requires the reinsurer to accept financial responsibility for funds transferred to it by a primary insurer through an intermediary
- Unauthorized reinsurance clause—specifies requirements that an unauthorized reinsurer must satisfy for the primary insurer to receive favorable accounting treatment for the reinsurance transaction
- Funding clause—requires the certified reinsurer to provide security in an amount sufficient to avoid the imposition of a financial statement penalty on the primary insurer

Financial and Market Conduct Oversight

The insurance statutes in various states require or permit the state's insurance department to periodically examine the financial affairs and market conduct of all insurers, including reinsurers authorized to do business in the state. The state insurance department is usually required to examine all domestic insurers at least once every three to five years and can initiate an examination whenever it is deemed expedient. Authorized foreign and alien insurers are also examined periodically in conformance with NAIC association examinations. **Financial examination** is one of the many tools insurance regulators use to oversee the financial position of insurers. Similarly, market analysis, including market-conduct examinations, is a tool used by regulators to oversee the marketing activities of insurers.

Financial examination
An analysis of an insurer's operations and financial condition to determine if the insurer meets the financial requirements to sell insurance in a particular state.

Financial Examination

In a financial examination, a team of state insurance department examiners confirms that financial reporting procedures and requirements are being followed. This confirmation includes verifying that assets shown on financial statements actually exist and are properly valued, as well as determining that all liabilities have been identified and are properly valued.

Examiners audit and verify underwriting results and investment income (including capital gains and losses on the sale of investment assets). They also examine premiums earned; losses and loss adjustment expenses paid and incurred; changes in unpaid loss and loss adjustment expense reserves; and all reinsurance in force by type of insurance. If the examination uncovers problems, the insurance department usually has broad powers to attempt to correct whatever problems are identified.

Market Analysis

Market conduct regulation deals with the behavior of insurers. For many years, market conduct regulators had to rely on observations of the marketplace and their professional judgment without the type of robust data found in financial regulation. As with police officers, they knew their beat and all the players, as well as when something was not quite right—which, in the case of regulators, meant that behavior did not appear to meet generally accepted market conduct standards or comport with matters specified in state law. Ultimately, however, market conduct regulators were reacting to behavior that had already occurred rather than proactively analyzing behavior based on a formalized, systematic approach.

In recent years, regulating the market conduct of insurance entities has matured toward a more rigorous and systematic analysis process. Regulators have worked together through NAIC to establish uniform market analysis practices and procedures. Today, the basic process for consistent and uniform market analysis is documented in the NAIC *Market Regulation Handbook*.

The goals of market analysis are threefold. First, it aims to find which of the thousands of companies writing insurance in the marketplace warrant further scrutiny by the insurance department. Second, it strives to identify which market conduct concerns are causing consumer harm and should be addressed by the insurance department. The third, and arguably most critical, goal is to predict noncompliant behavior before it happens. This goal has yet to be achieved, and might not be achievable, but predictive market analytics is often discussed, along with the types of data needed to accomplish this goal, whenever methods for improving market analysis are considered.

Regulators rely on data gathered from a variety of sources to monitor the marketplace. Their goal is to spot disruptions as early as possible and resolve them effectively and efficiently. To do so, market analysts must organize, analyze, and evaluate the data.

Because an insurer may operate in many states, regulators in each state must have confidence in the analytical abilities of the other states. Working through NAIC, market conduct regulators have developed a three-stage process that all members are encouraged to use that promotes uniformity, completeness, and collaboration among states. The three stages organize the market analysis cycle into a funnel-shaped process, moving from a large overview of the entire marketplace to single concerns about individual entities.

At each stage of the process, the level of detail that the analyst uses moves from summary to transactional-level data. By the time the analysis is completed, the insurance department should have enough detailed information to choose the appropriate next step(s) from the continuum of regulatory responses. There are several regulatory tools available to assist the analyst in making an informed decision about next steps. Included in the toolkit are: corresponding with the insurer, contacting the insurer by phone, performing desk audits, administering market-conduct examinations, and taking administrative action against the insurer.

Reinsurance Regulation Developments

Although reinsurers continue to be regulated in the U.S. at the state level, a number of developments in recent years have changed the regulatory landscape to some degree. NAIC's Solvency Modernization Initiative (SMI) focuses on five key solvency areas: capital requirements, international accounting, insurance valuation, reinsurance, and group regulatory issues. It has resulted (and will continue to result) in a variety of modifications and enhancements to the state regulatory system. "The SMI is a critical self-examination of the United States' insurance solvency regulation framework and includes a review of international developments regarding insurance supervision, banking supervision, and international accounting standards and their potential use in U.S. insurance regulation."[1]

In addition, a federal role for insurance was created with the passage of the Dodd-Frank Act, which established the Federal Insurance Office (FIO) and includes the Non-Admitted and Reinsurance Reform Act (NRRA). U.S. reinsurers are also potentially subject to the actions of several other domestic functional regulators, including the Securities and Exchange Commission (SEC), the Financial Stability Oversight Council (FSOC), the Federal Reserve Board (if a reinsurer is deemed systemically important or is part of a bank/thrift holding company), the Treasury Department, and credit rating agencies (often described as the de facto regulators). These various regulators result in multiple, and perhaps conflicting, obligations regarding financial reporting, corporate governance, solvency assessment, and data collection.

Further, as insurance and reinsurance regulation becomes increasingly globalized, U.S. insurers and reinsurers are subject, both directly and indirectly, to international regulation. Accordingly, U.S. insurers and reinsurers must be cognizant of international regulatory developments, particularly those of the International Association of Insurance Supervisors (IAIS). These developments include the IAIS's work on its Common Framework for the Supervision of Internationally Active Insurance Groups (ComFrame), which is intended to provide supervisors with a supervisory framework for internationally active insurance groups.

Another significant international regulatory initiative is the European Union's development of Solvency II, which aims to establish a revised set of EU-wide capital requirements and risk management standards that will replace the current solvency requirements. Although neither ComFrame nor Solvency II have been implemented, both contemplate potentially substantial regulatory changes that will affect the reinsurance industry.

FINANCIAL SOLVENCY OVERSIGHT

Individual consumers and most businesses do not have the skills or resources to analyze claim-paying ability when selecting an insurer. However, because insurers hold large sums of money paid by consumers for long periods of time, their financial strength must be carefully monitored to ensure their continued ability to pay covered claims, in both the present and future. The United States regulatory framework helps to maintain insurers' solvency and thus to protect the interests of consumers, while also facilitating an effective and efficient marketplace for insurance products.

The U.S. regulatory framework is a national system of state-based regulation in which regulatory responsibility for insurer solvency monitoring rests with the state insurance regulator. State insurance regulators are assisted by the **National Association of Insurance Commissioners (NAIC)**, which shares with them its financial, actuarial, legal, technological, research, and economic expertise in order to help state regulators meet their regulatory goals.

National Association of Insurance Commissioners (NAIC)
An association of insurance commissioners from the fifty U.S. states, the District of Columbia, and the five U.S. territories and possessions, whose purpose is to coordinate insurance regulation activities among the various state insurance departments.

The U.S. regulatory framework relies on an extensive system of peer review, characterized by frequent communication and collaboration to provide the necessary checks and balances needed to make the system work. Much of this collaboration occurs through NAIC, where the diverse perspectives of its members are reflected in solutions embodied in model laws and regulations. These solutions have resulted in a risk-focused approach that is constantly evolving to meet changing local, national, and international developments. While NAIC has no direct regulatory authority, it provides a forum to develop uniform policy, when appropriate, that has a profound effect on the nature and consistency of state regulation.

Additionally, the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act) has changed the way solvency oversight of reinsurers is performed. The new law provides that if the state of domicile of a reinsurer is an NAIC-accredited state or has financial-solvency requirements substantially similar to the requirements necessary for NAIC accreditation, that state shall be solely responsible for regulating the financial solvency of the reinsurer.

To monitor insurer solvency, state insurance regulators employ a variety of financial regulatory tools that NAIC has developed over time and maintains—testing, evaluating, and changing as needed. See the exhibit "NAIC Regulatory Tools."

NAIC Regulatory Tools

- NAIC Annual Statement
- NAIC model laws and guidelines
- NAIC accreditation program
- Off-site monitoring and analysis
- On-site, risk-focused examinations
- Insurance Regulatory Information System (IRIS)
- NAIC risk-based capital (RBC) system

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NAIC Annual Statement

One of the core principles of insurance regulation addresses reporting financial information, including disclosure and transparency. Insurers are required to file standardized reports annually and quarterly to assess their risk and financial conditions. These reports contain both qualitative and quantitative information, and they are updated as necessary to incorporate significant common insurer risks.

NAIC Annual Statement
The primary financial statement prepared by insurers and required by every state insurance department.

The **NAIC Annual Statement** is a specified format for financial reporting. An NAIC committee annually reviews and revises this format, called a "blank," so that it continues to meet the reporting needs of state insurance departments. Insurers file an NAIC Annual Statement on or before March 1 with insurance departments for each state in which they are authorized to transact business. The Financial Annual Statement Report is made electronically to a single source—NAIC. The common reporting format and electronic filing simplify the task of solvency surveillance by state insurance departments and reduce the reporting burden for insurers operating in multiple jurisdictions.

Insurer financial reporting requirements have developed separately from those of noninsurers. Accounting rules and procedures used to prepare the NAIC Annual Statement are called statutory accounting principles (SAP). These procedures are conservative and generally value insurer assets and liabilities as if the insurer were being liquidated immediately. In contrast with the accounting approach used by noninsurers, this approach generally requires understating assets and overstating claim liabilities, resulting in an intentional understatement of the insurer's net worth (policyholders' surplus).

State insurance regulators use the NAIC Annual Statement to determine the extent to which a primary insurer relies on reinsurance. Reinsurance transactions usually modify a primary insurer's financial position. The detailed information contained in the NAIC Annual Statement schedules enables state insurance regulators to determine if reinsurance transactions have masked underlying financial instability.

NAIC Model Laws and Guidelines

When a new problem or issue arises in the insurance industry, regulators can respond collectively through NAIC by developing a **model law** for each state legislature to consider for possible enactment. A model law may not be passed in its exact form by every state, but it provides a common basis for drafting state laws. Consequently, certain aspects of insurance regulation are relatively uniform among states.

Model law

A document drafted by the NAIC, in a style similar to a state statute, that reflects the NAIC's proposed solution to a given problem or issue and provides a common basis to the states for drafting laws that affect the insurance industry. Any state may choose to adopt the model bill or adopt it with modifications.

NAIC has proposed over 200 model laws. Many of them influence reinsurance reporting requirements, but only a few are considered directly applicable to reinsurance transactions, such as the Credit for Reinsurance Model Law and the Reinsurance Intermediary Model Act.

NAIC Accreditation Program

The NAIC Accreditation Program was established to develop and maintain standards to promote sound insurance company financial solvency regulation. The purpose of the accreditation program is for state insurance departments to meet baseline standards of solvency regulation, particularly with respect to regulation of multistate insurers. Accreditation is a certification given to a state insurance department that has demonstrated meeting and continuing to meet an assortment of legal, financial, and organizational standards as determined by a committee of its peers.

Uniformity of approach to financial regulation has been facilitated by the NAIC accreditation program. As part of the peer review process, the accreditation program subjects state insurance regulators to a thorough and comprehensive evaluation to determine if the state has met minimum, baseline standards of solvency regulation. To become accredited, the state must submit to a full on-site accreditation review. Depending on the review's results, the state is either accredited or not (that is, a pass/fail system is used). To remain accredited, an accreditation review must be performed at least once every five years with interim annual reviews.

The accreditation review looks at these factors:

- The adequacy of the state's solvency laws and regulations to protect consumers
- The ability of the regulator to meet standards regarding effective and efficient financial analysis and examination processes based on the priority status of insurers
- The ability and willingness of the state regulator to cooperate and share pertinent information with other state, federal, or foreign regulatory officials
- The ability of a state to take timely and effective action when an insurer is identified as financially troubled or potentially troubled

- The quality of the state regulator's organizational and personnel practices
- The effectiveness of the state's processes for company licensing and review of proposed changes in control

At the present time, all fifty states, the District of Columbia, and Puerto Rico are accredited. However, there have been several occasions when not all states have been accredited. Under the NAIC Accreditation Program, accredited states are not required to accept the results of insurer examinations performed by states that have not been accredited.

The Credit for Reinsurance Model Law and the Reinsurance Intermediary Model Act are two of the model laws required in the minimum standard for state insurance department accreditation.

Off-Site Monitoring and Analysis

Another core insurance regulatory principle involves the concept of off-site monitoring and analysis. Insurance regulators use off-site monitoring and analysis to assess, on an ongoing basis, the financial condition of an insurer as of the valuation date and to identify and assess current and prospective risks through risk-focused surveillance.

The results of an off-site analysis are included in an insurer profile for continual solvency monitoring. Many off-site monitoring tools are maintained by NAIC, such as the NAIC proprietary Financial Analysis Solvency Tools (FAST).

On-Site, Risk-Focused Examinations

A similar core insurance regulatory principle involves the concept of on-site, risk-focused examinations. U.S. regulators carry out risk-focused, on-site examinations in which an insurer's corporate governance, management oversight, and financial strength are evaluated, including the system of risk identification and mitigation, both on a current and prospective basis. The reported financial results are assessed through the financial examination process, and a determination is made of the insurer's compliance with legal requirements.

An NAIC association examination is also called a zone or multistate examination. NAIC recommends an association examination for insurers licensed in more than one zone or in more than three jurisdictions in a single zone. The fifty-six separate regulatory jurisdictions are divided by NAIC into four zones for purposes of conducting association examinations.

Whether a particular insurer is examined by one or more jurisdictions depends on the insurer's geographic scope of operations and the amount of insurance sold in each jurisdiction. If an insurer has annual direct written premiums of $1 million or more in a zone, or if at least 20 percent of its insurance sold (regardless of the dollar amount) is in a zone, that zone is invited to participate in the examination. In any event, any financial regulator wishing to participate in any examination is allowed to do so.

The insurance department of the insurer's state of domicile notifies NAIC when it proposes to examine an insurer. NAIC checks the premium volume shown in the insurer's most recent NAIC Annual Statement and notifies each zone's chair of its eligibility for participation through an automated process. Each zone chairman then designates one of the states within the zone to appoint an examiner to be the zone representative on the examination team. If all states within the zone waive participation, the entire zone waives participation and is not represented. An examiner-in-charge from the domiciliary state heads the examination team and is assisted by his or her staff and examiners representing each participating zone. The examiner-in-charge is responsible for outlining the examination scope in accordance with the provisions of the *NAIC Financial Condition Examiners Handbook*. Zone representatives can request investigation into areas of special interest to their state or members of their zone.

The examination report is prepared before the close of the examination and is presented to the insurer's officers for review and discussion. It contains summary financial statements from the insurer's most recent NAIC Annual Statement along with an analysis of specific findings resulting from the examination. The report also discusses any adverse findings and any material changes in the financial statements.

Insurance Regulatory Information System (IRIS)

The Insurance Regulatory Information System (IRIS) is a set of financial ratios developed by NAIC to assist regulators in evaluating an insurer's financial strength. The primary purpose of using the IRIS ratios is to identify insurers that are in the early stages of financial difficulty. The IRIS results are calculated from information provided in the Annual Statement Filing and stored in NAIC's computer system, where the results can be accessed by all state insurance regulators. IRIS test results can also help identify any specific areas that need immediate attention. Test results can assist state insurance regulators, along with other proprietary regulatory tools, in determining priorities for special on-site examinations.

Several of the IRIS ratios are affected by reinsurance or are used to evaluate an insurer's dependence on reinsurance. One of these is the capacity ratio, which is used to measure an insurer's ability to sell more insurance and, therefore, to grow its market share. The capacity ratio compares an insurer's net written premiums (which represent its exposure to potential claims) with its policyholders' surplus (which represents its financial capacity for absorbing losses). If losses and expenses exceed net written premiums, an insurer must use its surplus to meet its obligations. Therefore, an insurer's net written premiums should not become too large relative to its policyholders' surplus.

Although state insurance regulators review a number of financial ratios to evaluate the financial position of an insurer, the capacity ratio is considered key because it indicates that an insurer might have become financially overextended by selling too much insurance. A capacity ratio that is greater than 3 to 1 is typically considered to be outside acceptable limits. One use of reinsurance is to provide insurers with surplus relief, which enables them to keep their capacity ratio within acceptable limits.

Another IRIS ratio affected by reinsurance is the surplus aid to surplus ratio. This ratio evaluates the insurer's dependence on ceding commissions from reinsurance. If the ceding commission on unearned ceded premiums exceeds 25 percent of the insurer's policyholders' surplus, the ratio is considered unsatisfactory.

The IRIS change in surplus ratio considers the percentage change in the insurer's policyholders' surplus during the year. A 10 percent or greater decrease in policyholders' surplus or an increase of 50 percent or greater is considered unusual and may trigger scrutiny. Large increases in policyholders' surplus may result from several factors, one of which is reinsurance transactions that provide surplus relief.

NAIC Risk-Based Capital (RBC) System

Insurers are required to maintain reserves and capital at all times and in such forms that provide an adequate margin of safety. The most visible measure of capital adequacy requirements is associated with the NAIC risk-based capital (RBC) system. This system determines the minimum amount of capital an insurer needs to support its operations, given its risk characteristics. Before adopting the NAIC RBC system, state insurance codes made little or no allowance for the risk differentials among insurers when specifying minimal capital requirements.

In the context of the NAIC RBC system, risk characteristics are categorized into multiple risks, including these:

- Asset risk—the risk that an asset's value will be lower than expected
- Underwriting risk—the loss volatility of the types of insurance sold
- Credit risk—the risk that the insurer will be unable to collect monies owed to it

The RBC calculation uses a standardized formula to benchmark specified levels of regulatory actions for weakly capitalized insurers. It is intended to be a minimum regulatory standard for the amount of capital and not necessarily the full amount of capital that an insurer would want to hold to meet its objectives. Additionally, RBC is not designed to be used as a stand-alone tool in determining financial solvency of an insurer. It is just one of the many tools that can give state insurance regulators legal authority to take action over an insurer if it is found to be in poor financial condition.

REGULATORY OVERSIGHT OF REINSURANCE TRANSACTIONS

Reinsurance is an essential tool of insurer management. How primary insurers use reinsurance to manage the risks they assume is an important issue for insurance regulators. As a result, state legislatures and Congress have enacted laws that affect reinsurance transactions.

State insurance regulators have these key regulatory concerns about reinsurance:

- The standards by which a primary insurer should be allowed to take credit for a reinsurance transaction
- The creditworthiness of reinsurers
- The creditworthiness of reinsurance intermediaries
- Contract certainty

Credit for a Reinsurance Transaction

State insurance regulators have allowed primary insurers to take credit for reinsurance transactions on their financial statements based on the reinsurers' authorization status and other conditions, rather than on the actual value of the economic benefit that the reinsurance transaction provides. However, some reinsurance agreements, categorized as finite risk reinsurance agreements, depart from traditional reinsurance transactions in that only a limited amount of insurance risk is transferred from the primary insurer to the reinsurer. Consequently, state insurance regulators have adopted requirements that must be met for a reinsurance agreement to be treated as a reinsurance transaction.

Finite risk reinsurance agreements are the focus of these requirements because they have been used to enhance the appearance of a primary insurer's financial condition without actually improving it. These agreements often contain complex and sophisticated provisions that have caused state insurance regulators and accounting organizations to revisit the criteria under which credit for reinsurance is granted.

These are the key sources that affect credit for reinsurance transactions:

- National Association of Insurance Commissioners (NAIC) Credit for Reinsurance Model Law and Regulation
- Primary insurer's balance sheet, as reflected by reinsurance
- Accounting requirements

NAIC Credit for Reinsurance Model Law and Regulation

The NAIC Credit for Reinsurance Model Law and Regulation allows a primary insurer to take credit for reinsurance as an asset on its NAIC Annual

Statement if the reinsurer is licensed or accredited in the state in which the primary insurer is domiciled. The primary insurer can also take credit for reinsurance if the reinsurer is licensed or accredited in another state that has standards similar to the state in which the primary insurer is domiciled. Further, the act allows primary insurers to take credit for unauthorized reinsurance if the reinsurer's obligations are secured with collateral, such as trust accounts, letters of credit, and trust funds.[2]

In November 2011, NAIC adopted revisions to the Credit for Reinsurance Model Law (#785) and Credit for Reinsurance Model Regulation (#786). These revisions serve to reduce reinsurance collateral requirements for unauthorized reinsurers that are licensed and domiciled in qualified jurisdictions. They establish a certification process in which each state that adopts them gains the authority to approve reinsurers for collateral reduction on the basis of certain criteria—including, but not limited to, financial strength, business practices, and the effectiveness of reinsurance supervision in the reinsurer's domiciliary jurisdiction. A certified reinsurer will be required to post collateral in an amount that corresponds with its assigned rating in order for a primary insurer to be allowed credit for the reinsurance ceded.

The NAIC revisions also acknowledge the Nonadmitted and Reinsurance Reform Act (NRRA), part of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act), which changed the way in which credit for reinsurance transactions occurs. NRRA provides that if the state of domicile of a primary insurer is an NAIC-accredited state, or has financial solvency requirements substantially similar to the requirements necessary for NAIC accreditation, and recognizes credit for reinsurance for the primary insurer's ceded risk, then no other state may deny the credit for reinsurance. In effect, this consolidates the power to grant or deny credit for a reinsurance transaction to a single state—the state of domicile of the primary insurer. Because credit for reinsurance is now governed by the laws and regulations of the domestic state of the primary insurer, each state may develop its own reinsurance collateral reforms. However, states may voluntarily act together through the NAIC to achieve the goals of reinsurance modernization.[3]

Primary Insurer's Balance Sheet

Capacity ratio (premium-to-surplus ratio)
A leverage ratio that indicates an insurer's financial strength by relating net written premiums to policyholders' surplus.

Unearned premium reserve
An insurer liability representing the amount of premiums received from policyholders that are not yet earned.

State insurance regulators focus solvency examinations on the adequacy of a primary insurer's capital, as shown on its balance sheet, and on the various risks an insurer faces. Among other considerations, state insurance regulators use the **capacity ratio** to determine if a primary insurer has sold more insurance relative to its financial resources than is considered financially prudent. Reinsurance affects a primary insurer's balance sheet and facilitates market share growth that would otherwise be limited by statutory accounting principles (SAP).

Under SAP, income and expenses are mismatched. SAP requires insurers to establish an **unearned premium reserve** to repay insureds who decide to cancel their policies. Premiums are recognized as income only as they are earned; however, in contrast, SAP requires that policy-related expenses be charged immediately. Because the insurer is required to charge these expenses against income it has not yet earned, it must take money from its policyholders' surplus to pay these initial expenses. The more insurance sold, the greater the reduction in policyholders' surplus. This is referred to as the surplus drain caused by growth in written premiums.

A primary insurer may purchase pro rata reinsurance to alleviate surplus drain. Pro rata reinsurance reduces net written premiums (the numerator of the capacity ratio) because ceding the reinsurance premium transfers a portion of the obligation to maintain unearned premium reserve to the reinsurer. Policyholders' surplus (the denominator of the capacity ratio) increases by the amount of ceding commission received from the reinsurer. The net effect is a reduction in the capacity ratio.

To illustrate, assume that Spring Insurance Company (Spring) opened for business on December 31, 20X3. On that date, it had $500,000 in cash and $1.5 million in investments. On January 1, 20X4, it sold and collected $5 million of written premiums on one-year policies. In selling these policies, Spring incurred $1.5 million in expenses for producer commissions, premium taxes, and internal costs, such as underwriting and policy issuance.

The exhibit shows the balance sheet for Spring on January 1, 20X4, as it would have appeared if Spring had not purchased reinsurance, compared with ceding half of its premiums to a reinsurer and receiving a 30 percent ceding commission on the reinsurance premium. See the exhibit "Balance Sheet for Spring Insurance Company, January 1, 20X4."

Spring's capacity ratio has been reduced to 2 to 1 from 10 to 1 because of the purchase of pro rata reinsurance. First, net written premiums decreased from $5 million to $2.5 million because of the reinsurance cession. Second, policyholders' surplus increased from $500,000 to $1.25 million because of the reimbursement of $750,000 of prepaid expenses, equal to the 30 percent ceding commission paid by the reinsurer on the $2.5 million of written premiums ceded.

The "Balance Sheet for Spring Insurance Company, January 1, 20X4" exhibit illustrates the surplus relief function of reinsurance—reducing surplus drain that results from having to maintain an unearned premium reserve.

In the past, some reinsurance transactions were structured so that poorly capitalized primary insurers received surplus relief without any transfer of insurance risk, typically using one of two methods. The first method was to have a reinsurance transaction in which all of the primary insurer's losses were reimbursed by the reinsurer and eventually paid back by the primary insurer. The second method was to have a reinsurance transaction that commenced on the last day of the calendar year and terminated on the first day of the following year to improve the balance sheet for NAIC Annual Statement purposes only.

Balance Sheet for Spring Insurance Company, January 1, 20X4

	Without Reinsurance	With Reinsurance
Assets		
Cash	$4,000,000[1]	$2,250,000[2]
Investments	1,500,000	1,500,000
Total Assets	$5,500,000	$3,750,000
Liabilities		
Unearned Premium Reserve	$5,000,000	$2,500,000[3]
Total Liabilities	5,000,000	2,500,000
Policyholders' Surplus	500,000	1,250,000
Total Liabilities and Policyholders' Surplus	$5,500,000	$3,750,000
Capacity Ratio	10 to 1	2 to 1

1 $500,000 (existing cash) + $5,000,000 (written premiums) – $1,500,000 (policy acquisition expenses).

2 $500,000 (existing cash) + $2,500,000 (50 percent of $5,000,000 written premiums) + $750,000 (the ceding commission; 30 percent of $2,500,000) – $1,500,000 (policy acquisition expenses).

3 Spring's unearned premium reserve was reduced from $5,000,000 to $2,500,000 because the reinsurer assumed responsibility for maintaining this liability when it assumed the $2,500,000 in written premiums.

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These methods for circumventing solvency regulation have largely disappeared because changes in accounting rules, which were primarily directed at finite reinsurance transactions, have eliminated the benefit that insurers sought through them. Because the potential exists for these transactions to obscure the insurer's true financial condition, several accounting requirements were developed.

Accounting Requirements

In the late 1970s and early 1980s, state insurance regulators and accounting organizations began questioning whether certain transactions should continue to qualify for accounting treatment as reinsurance transactions. In 1992, the Financial Accounting Standards Board (FASB) issued its Statement No. 113, "Accounting and Reporting for Reinsurance of Short-Duration and Long-Duration Contracts" (FAS 113). Long-duration contracts are contracts that are expected to remain in force for an extended period, such as endowment contracts. All other contracts, including the majority of property and liability contracts, are classed as short-duration contracts.

According to FAS 113, a short-duration transaction qualifies for reinsurance accounting treatment if these two requirements are met:

- The reinsurer assumes significant insurance risk under the reinsured portions of the underlying insurance contracts.
- It is reasonably possible that the reinsurer may realize a significant loss from the transaction.

FAS 113 defines "insurance risk" as including both underwriting risk and timing risk. Underwriting risk is described as the uncertainty about the ultimate amount of any premiums, commissions, claims, and claim settlement expenses. Timing risk is described as the uncertainty about the timing of premiums, commissions, claims, and claim settlement expenses. "Reasonably possible" and "significant loss" are not specifically defined. Therefore, FAS 113 provides limited guidance about whether a particular transaction can be accounted for as reinsurance.

These accounting requirements, which apply to insurer financial statements that are based on Generally Accepted Accounting Principles (GAAP), affect an insurer's ability to use finite risk reinsurance to improve its financial condition. Although FAS 113 does not apply to the NAIC Annual Statement, the NAIC has adopted similar requirements in its Statement of Statutory Accounting Principles (SSAP) No. 61, "Life, Deposit-Type and Accident and Health Reinsurance," and SSAP No. 62, "Property and Casualty Reinsurance." Also, regulators in some states prohibit certain types of finite risk reinsurance transactions.

Creditworthiness of Reinsurers

Primary insurers that have reinsurance agreements with authorized or otherwise accredited reinsurers are permitted to show amounts owed to them by reinsurers as assets on their balance sheets. These reinsurance recoverables, such as the amounts owed to primary insurers for unreimbursed losses, are often significant.

Because failure of a primary insurer to collect these amounts from reinsurers would affect that insurer's solvency, NAIC requires insurers to provide extensive information about their reinsurance transactions in **Schedule F** of the NAIC Annual Statement.

Schedule F
The NAIC Annual Statement Schedule that shows specific information about ceded and assumed reinsurance, as well as portfolio transfers.

United States ceding insurers are not allowed credit for reinsurance with respect to agreements with unauthorized or certified reinsurers unless the reinsurer provides the appropriate amount of collateral in the form of letters of credit, trust agreements, or funds deposited by and withheld from reinsurers.

A letter of credit is a form of payment guarantee issued by a bank. To be acceptable collateral, it must meet these criteria:

- The letter of credit must be clean; that is, not conditioned on the delivery of any other documents or materials that would inhibit obtaining the funds.
- The letter of credit must be irrevocable; that is, it cannot be modified or revoked without the beneficiary's consent, once the beneficiary is established.
- The letter of credit must contain an evergreen clause, which automatically renews the letter of credit for a specific time unless the issuer of the letter of credit signifies its intent not to renew the letter at expiration.
- The letter of credit must be issued by an approved bank, which is a U.S. financial institution that is organized or licensed under state or federal laws; regulated, supervised, and examined by U.S. federal or state bank regulatory authorities; and determined by the NAIC Securities Valuation Office to have adequate financial condition and standing.

Trust agreements, surety bonds, cash, and other liquid assets may also constitute acceptable collateral for many insurance and reinsurance transactions. Some unauthorized alien reinsurers choose to collateralize their obligations to U.S. insurers through multibeneficiary trust funds. Reinsurers must fund these trusts with 100 percent of their gross liabilities, plus an additional buffer amount of $20 million. (Lloyd's of London is required to maintain an additional buffer amount of $100 million.) Trusts must be funded in the form of cash, marketable securities meeting specific standards, or letters of credit.

The 100 percent collateral requirement for unauthorized reinsurers has been the subject of debate with NAIC for several years by international parties, including reinsurers, regulators, and policymakers. These parties have contended that losses arising out of U.S. claims are actually paid from the international reinsurers' loss reserves, not from the trust funds that serve as collateral. International reinsurers have also argued that maintaining a fully funded trust for U.S. claims in addition to their own loss reserves has increased their cost of capital to operate in the U.S., which is one of only a few countries imposing the 100 percent collateral requirement. The 2011 revisions to the NAIC credit for reinsurance models serve to reduce these collateral requirements for non-U.S. licensed reinsurers, as well as unauthorized U.S. reinsurers, that meet certain criteria for financial strength and business practices and are domiciled and licensed in qualified jurisdictions.

To offset the drain on policyholders' surplus resulting from doing business with unauthorized reinsurers, primary insurers may withhold amounts due to the reinsurers. These amounts consist mostly of the reinsurance premium that the primary insurer owes the reinsurer, but also may include salvage and subrogation recoveries, as well as other miscellaneous amounts. The amounts withheld as deposits are usually negotiated in the reinsurance agreement and expressed as a percentage of the reinsurance premium. If the amounts withheld are inadequate to cover the reinsurer's obligations, then subsequent losses are billed to the reinsurer.

In severe cases, a **commutation agreement** may be the best way to limit problems with collecting reinsurance recoverables. In return for cash, the primary insurer withdraws the liability for outstanding losses and loss-adjustment expenses related to the commuted reinsurance agreement. However, a commutation agreement does not necessarily enable a primary insurer to collect from a delinquent reinsurer.

Commutation agreement
An agreement that specifies how to value, settle, and discharge all obligations between parties to a reinsurance agreement.

Creditworthiness of Reinsurance Intermediaries

The creditworthiness of reinsurance intermediaries came into question after the landmark Pritchard & Baird case. Regulatory action in the aftermath of this case, such as New York Regulation 98, required that reinsurers assume the credit risk associated with using a reinsurance intermediary and led to the NAIC Reinsurance Intermediary Model Act, which specifies requirements for reinsurance intermediaries.

Pritchard & Baird Case

Pritchard & Baird was once one of the largest reinsurance intermediary firms in the U.S. Contrary to industry practice, Pritchard & Baird deposited all monies, including those of its primary insurer and reinsurer clients, into a single bank account. Without the knowledge of its clients, the firm's principal owners withdrew increasing amounts of money from the firm's account, characterizing them as loans. Because of inadequate accounting records, the total amount of those withdrawals could not be determined. By 1975, the firm was having difficulty paying its clients. One primary insurer filed suit, and Pritchard & Baird was forced into bankruptcy.

The reinsurers argued that because Pritchard & Baird acted as the agent for the primary insurers, payments by reinsurers to Pritchard & Baird constituted payment to the primary insurers and that payments by the primary insurers to Pritchard & Baird did not constitute payments to the reinsurers. Consequently, they concluded, any losses from the bankruptcy should fall on the primary insurers. The primary insurers took the opposite position and argued that Pritchard & Baird acted as agent for the reinsurers, thus any losses from the bankruptcy should fall on the reinsurers.

After reviewing the operating methods of Pritchard & Baird to determine the nature of their agency relationship, the court held that the primary insurers, and not the reinsurers, exercised primary supervision of Pritchard & Baird. This conclusion was reached because Pritchard & Baird received prior authorization and approval from the primary insurers for many of its activities. Pritchard & Baird was presumed to have acted as an agent for the primary insurers; therefore the court decided that the losses resulting from Pritchard & Baird's failure to send premiums to the reinsurers should fall on the primary insurers.

This decision does not mean that every reinsurance intermediary is considered to be an agent of the primary insurer. In other cases, courts have concluded that reinsurance intermediaries represent reinsurers. Determining which party an intermediary represents depends on the degree of control exercised by the primary insurer compared with the control exercised by the reinsurer.

New York Regulation 98

Largely as a result of the Pritchard & Baird case, the New York legislature in 1976 required the licensing of reinsurance intermediaries and authorized the New York Insurance Department to examine and regulate reinsurance intermediaries. In 1982, the New York Insurance Department adopted Regulation 98, which applies to primary insurers licensed in New York (wherever domiciled). In accordance with this regulation, to take credit for ceded reinsurance on their financial statements, these primary insurers must have an intermediary clause in their reinsurance agreements when reinsurance intermediaries are involved in reinsurance transactions. Many other states followed New York's lead and required an intermediary clause.

As the intermediary clause specifies that payments made by the primary insurer to a reinsurance intermediary are deemed to have been received by the reinsurer, the reinsurer assumes the credit risk if the reinsurance intermediary defaults. The clause makes the reinsurance intermediary the reinsurer's agent for the purpose of receiving and transmitting funds, which is the opposite of the Pritchard & Baird decision.

This relationship addresses the concern that placing the reinsurance intermediary's credit risk on the primary insurer could lead to solvency problems for the primary insurer and consequently harm insureds. The intermediary clause does not address the question of whom the reinsurance intermediary represents for other purposes, such as receiving and transmitting information. This question must still be answered by reviewing the parties' apparent intent.

New York Regulation 98 also states these explicit obligations of reinsurance intermediaries:

- The reinsurance intermediary must have written authority from the primary insurer before it negotiates or accepts any reinsurance agreement for the primary insurer. The written authorization must indicate at least: (1) the name of the primary insurer (and affiliates, if any), (2) the types of insurance to be reinsured, (3) the kinds of reinsurance or retrocessions to be negotiated on that specific transaction, (4) the amounts of insurance, and (5) the effective date and the expiration date of the authority.
- When the reinsurance intermediary negotiates a reinsurance agreement, it must give prompt written notice to the primary insurer. Such notice must be accompanied by written evidence that the assuming reinsurer or reinsurers have agreed to assume the liability for certain loss exposures.
- If the reinsurance intermediary places reinsurance with a reinsurer that is not licensed in, or accredited by, the state of New York, the reinsurance intermediary must make a reasonable inquiry about the financial

strength of such reinsurer. At the primary insurer's request, the reinsurance intermediary must furnish any information obtained in its inquiry along with a recent financial statement of the reinsurer. The primary insurer can release the reinsurance intermediary from this duty in writing if it chooses.

- The reinsurance intermediary must notify the primary insurer of any conflicts of interest that the intermediary has at the beginning of the relationship or that may arise in the future. Such conflicts could arise from ownership or control of the reinsurance intermediary by a reinsurer, ownership of a reinsurer by the reinsurance intermediary, retrocessional placements by the reinsurance intermediary on a reinsurer's behalf, underwriting agency agreements, or similar relationships or transactions.
- The reinsurance intermediary must maintain records adequate to permit an audit of its activities to ensure that it has complied with all statutes and regulations. Regulation 98 specifies the minimum information required. The information must be maintained for at least ten years.
- The reinsurance intermediary must deposit funds received from primary insurers and reinsurers in at least one bank account separate from the accounts in which the reinsurance intermediary's funds are deposited. Funds can be withdrawn from these accounts only (1) to transmit funds to primary insurers or reinsurers in the normal course of business, (2) to pay commissions due to the reinsurance intermediary and, if authorized in writing, to pay for interest on the deposited funds, (3) to pay commissions due to others, and (4) to pay federal excise taxes.

Regulation 98 was the first significant attempt to regulate reinsurance intermediaries either in the U.S. or abroad.

NAIC Reinsurance Intermediary Model Act

In December 1989, NAIC introduced the Reinsurance Intermediary Model Act. Several technical amendments to the act were added in June 1990. The purpose of the act is to specify requirements for reinsurance intermediaries, including licensing, and to give state insurance departments examination authority over reinsurance intermediaries. The majority of states have adopted the Reinsurance Intermediary Model Act or similar legislation.

The Reinsurance Intermediary Model Act has several provisions similar to New York's Regulation 98. It differs in that it requires the licensing of reinsurance intermediaries, and it distinguishes between reinsurance intermediary brokers and reinsurance intermediary managers. A reinsurance intermediary broker places reinsurance on a primary insurer's behalf but does not have the power to bind the primary insurer. A reinsurance intermediary manager does have the power to bind the primary insurer. New York has retained Regulation 98 rather than adopt the Reinsurance Intermediary Model Act.

The Reinsurance Intermediary Model Act contains these provisions that apply to reinsurance intermediary brokers:

- The reinsurance intermediary broker must obtain a license in each state in which it does business. An exception to this requirement is that if the reinsurance intermediary broker does not have an office in a state in which it does business, it must either be licensed in the state as a nonresident reinsurance intermediary or be licensed in a state having substantially similar laws.
- The reinsurance intermediary broker must have a written authorization with each primary insurer with which it works. At a minimum, the written authorization must specify that (1) the primary insurer can terminate its authority at any time, (2) the reinsurance intermediary broker must account for all transactions and remit all funds due the primary insurer within thirty days of receipt, (3) the reinsurance intermediary broker must hold all funds in a fiduciary capacity in a qualified U.S. financial institution, (4) the reinsurance intermediary broker must comply with any written standards of the primary insurer about cession and retrocession of liability for all loss exposures, and (5) the reinsurance intermediary broker must disclose any relationship with any reinsurer with which it does business.
- The reinsurance intermediary broker must keep books and records that provide proof of the placement for at least ten years after each agreement expires.
- The primary insurer must have access to, and the right to copy and audit, all accounts and records maintained by the reinsurance intermediary broker.

The Reinsurance Intermediary Model Act also includes several sections on licensing, agreement provisions, and prohibited acts for reinsurance intermediary managers.

Contract Certainty

Until recently, regulatory requirements were aimed at ensuring that reinsurance contracts were signed within a reasonable period of time. Part of the NAIC accounting for reinsurance rules, known as the "Nine-Month Rule," requires that the reinsurance contract be finalized, reduced to written form, and signed within nine months of the policy period's commencement.

Following extensive litigation regarding the World Trade Center losses resulting from the terrorist attacks of September 11, 2001 (*Larry Silverstein v. Insurers of the World Trade Center*), which occurred because contracts were not consummated in written form prior to the loss, regulatory efforts began to focus on the concept of contract certainty. Contract certainty generally requires the complete and final agreement of all terms between the insured and insurer by the time the contract is entered into, with contract documentation provided promptly thereafter.

There is a lack of certainty when manuscript insurance and reinsurance contracts are negotiated, agreed to in principle, yet not consummated in written form. This lack of certainty, exemplified in the World Trade Center cases, led the State of New York to issue Circular Letter No. 20 in 2008 and a supplement to it in 2009. The circular letter requires insurers and reinsurers "to develop and implement practices to assure that policy documentation is delivered to the insured before, at, or promptly after inception," defining "promptly" to mean within thirty business days.

SUMMARY

Primary insurers and reinsurers are predominantly regulated at the state level. Fundamental purposes of these regulations are to ensure insurer solvency so that contractual commitments to insureds and claimants can be met and to promote healthy, competitive insurance markets. State insurance regulators control these aspects of primary insurers and reinsurers: licensing; rates and forms; and financial and market conduct oversight. Developments in reinsurance regulation include evolving roles for federal and international regulation.

NAIC is an organization of insurance regulators that coordinates insurance regulation activities among the various insurance departments. NAIC regulatory tools include these:

- NAIC Annual Statement—a specified format for financial reporting
- NAIC Model Laws and Guidelines—documents written in a style similar to that of state statutes that reflect NAIC's position on problems or issues in the insurance industry
- NAIC Accreditation Program—a formal program to provide consistency of solvency regulations among the states and improve the standards of solvency regulation and financial examinations conducted in all states
- Off-Site Monitoring and Analysis—the continuous monitoring and evaluation of financial information submitted by insurers and obtained from other sources to understand the financial position of the insurers
- On-Site, Risk-Focused Examinations—financial examinations of insurers by teams of state insurance regulators representing the zones in which the insurers operate
- IRIS—a set of financial ratios developed by NAIC to assist in evaluating an insurer's financial strength
- NAIC RBC System—a system developed by NAIC to determine the minimum amount of capital an insurer needs to support its operations, given its risk characteristics, and to provide a ladder of regulatory interventions if an insurer is found to be weakly capitalized

State insurance regulators' key concerns regarding reinsurance are the standards by which a primary insurer should be allowed to take credit for a reinsurance transaction, as well as the creditworthiness of reinsurers and reinsurance intermediaries. Reinsurance agreements have been subject to regulatory scrutiny because they can be used to obscure financial problems. The Pritchard & Baird case led to tighter regulation of reinsurance intermediaries, such as New York Regulation 98 and the NAIC Reinsurance Intermediary Model Act. Contract certainty remains an issue today, as regulators encourage insurers and reinsurers to document agreements in writing as soon as possible.

ASSIGNMENT NOTES

1. National Association of Insurance and the Center for Insurance Policy and Research, "Solvency Modernization Initiative (SMI)," www.naic.org/index_smi.htm (accessed December 21, 2012).
2. National Association of Insurance Commissioners, Credit for Reinsurance Model Regulation, NAIC Model #786 (Kansas City, Missouri: National Association of Insurance Commissioners, 2012), p. 786-4.
3. "Preface to Credit for Reinsurance Models," http://www.naic.org/documents/committees_e_reinsurance_related_docs_preface_adopted_ex_plenary_111106.pdf, p. 1 (accessed January 9, 2012).