REINSURANCE
ASSOCIATION
OF AMERICA

STATEMENT

TESTIMONY

OF

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SYSTEMIC RISK AND INSURANCE

UNITED STATES
HOUSE OF REPRESENTATIVES
SUBCOMMITTEE ON
CAPITAL MARKETS, INSURANCE AND
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My name is Frank Nutter and I am President of the Reinsurance Association of America (RAA). The RAA is a national trade association representing reinsurance companies doing business in the United States. RAA membership is diverse, including reinsurance underwriters and intermediaries licensed in the U.S., and those that conduct business on a cross border basis.

I am pleased to appear before you today to provide the reinsurance industry's perspective on systemic risk, how to improve oversight of the reinsurance industry, and how to restructure the federal government's role with regard to reinsurance. I commend Chairman Kanjorksi and Ranking Member Garrett for holding this important hearing and welcome the opportunity to address the Subcommittee. My testimony will highlight how reinsurance is regulated in the United States; why the current state-based insurance regulatory system does not work well for the sophisticated global reinsurance marketplace; how a federal reinsurance regulator could satisfy the concept of a systemic risk regulator of reinsurers; the need for a federal role in reinsurance; and the RAA's position in support of a single national regulator at the federal level for the reinsurance industry.

I. <u>Background on Reinsurance</u>

a. The U.S. Reinsurance Market

Reinsurance is critical to the insurance marketplace. It is a risk management tool for insurance companies to improve their capacity and financial performance, enhance financial security, and reduce financial volatility. It is widely recognized that reinsurance performs at least four primary functions in the marketplace: to limit liability on specific risks; to stabilize loss experience; to enable insurers to transfer major natural and man-made catastrophe risk; and to increase insurance capacity. Reinsurance is the most efficient capital management tool available to insurers.

Reinsurers have helped the U.S. recover from every major catastrophe over the past century. By way of example, 60% of the losses related to the events of September 11, 2001 were absorbed by the global reinsurance industry, and in 2005, 61% of Hurricanes Katrina, Rita and Wilma losses were ultimately borne by reinsurers. In 2008, approximately one-third of insured losses from Hurricanes Ike and Gustav were reinsured.

Reinsurance is a global business. Encouraging the participation of reinsurers worldwide is essential because reinsurance provides the much needed capacity in the U.S. for property, casualty and life risks. In 2008, for example, 20 of the world's leading life reinsurers held $7.6 trillion of U.S. life insurer mortality risk, and more than 2,600 foreign reinsurers from 70 jurisdictions[1] assumed property and casualty business from U.S. ceding insurers. Including their U.S. subsidiaries, foreign-owned reinsurance companies accounted for 83.6 percent of property casualty premiums ceded, while U.S. reinsurance companies accounted for 16.4 percent. Although the majority of U.S. premiums ceded offshore are assumed by reinsurers domiciled in ten countries, the entire market is required to bring much needed capital and capacity to support the extraordinary property, casualty and life risk exposure in the U.S. and to spread the risk throughout the world's financial markets.

b. U.S. Reinsurance Regulation

The state-based insurance regulatory system is focused on solvency regulation, with significant emphasis on regulating market conduct, contract terms, rates and consumer protection. The regulation of reinsurance, however, focuses almost exclusively on prudential regulation ensuring the reinsurer's financial solvency so that it can meet its future obligations to ceding insurers. Because the reinsurance transaction is between sophisticated business parties,

[1] Reinsurance Association of America (RAA), Offshore Reinsurance in the US Market--2008 Data (2009)

with no consumer component, there are no regulatory requirements relating to the rates that are negotiated between the parties or the forms used to evidence contractual terms.

Reinsurance is regulated by the states utilizing two different methods: direct regulation of U.S.-licensed reinsurers and indirect regulation of reinsurance transactions. States directly regulate reinsurers that are domiciled in their state, as well as those U.S. reinsurers that are simply licensed in their state, even if domiciled in another state. These reinsurers are subject to the full spectrum of solvency laws and regulations to which an insurer is subject, including: minimum capital and surplus requirements, risk-based capital (RBC) requirements, investment restrictions, required disclosure of material transactions, licensing, asset valuation requirements, examinations, mandated disclosures, unfair trade practices laws, annual statement requirements and actuarial-certified loss reserve opinion requirements.

The second method is indirect regulation of reinsurance transactions through the credit for reinsurance mechanism, which results in a financial statement accounting benefit given to an insurer if the reinsurance it has purchased meets certain prescribed criteria. If these criteria are met, the insurer may record a reduction in its insurance liabilities as a result of its reinsurance transactions. These criteria are contained in the state credit for reinsurance laws. In general, reinsurance credit is granted if the reinsurer is licensed in the same state as the cedent, if the reinsurer is accredited by the cedent's state of domicile, or if neither of these conditions apply, if the reinsurer has posted adequate security for its reinsurance obligations. One of the most widely utilized methods of security for a non-licensed reinsurer is the establishment of a U.S. trust fund or other security in the U.S., such as a clean, irrevocable and unconditional letter of credit issued by an acceptable institution, to cover its potential liabilities to the insurer. This provision is based on the historic premise that state regulators do not have the capability or resources to assess the legal, regulatory or accounting regimes of foreign jurisdictions, or the financial strength or claims-paying ability of reinsurers that are not authorized or licensed in the United States.

For several reasons, including the cumbersome nature of a multi-state licensing system, many new entrants into the reinsurance market have opted to establish a reinsurance platform outside the U.S. These new companies conduct business either through a U.S. subsidiary or by providing security through a trust or with collateral. Following the events of September 11, 2001, 12 new reinsurers with $10.6 billion capital were formed. After Hurricane Katrina, at least 38 new reinsurance entities with $17 billion of new capital were formed. Nearly all of this new capital came from U.S. capital markets, yet no new reinsurer was formed in the United States. Other than the U.S. subsidiaries of some of these new companies, not one U.S.-domiciled reinsurer has been formed since 1989. For these startups, the ease of establishment, capital formation, and regulatory approvals in non-U.S. jurisdictions contrasts with the cumbersome and protracted nature of obtaining licenses in multiple U.S. states.

c. Guaranty Fund System

Reinsurance is a business-to-business transaction involving knowledgeable commercial parties. State insurance guaranty funds were designed to provide a mechanism for the prompt payment of covered claims of an insolvent insurer to protect consumers and unsophisticated buyers of insurance products. Because the purpose behind establishing guaranty funds does not exist in reinsurance transactions, there are no reinsurance guaranty funds at the state level and there is no need to create one at the federal level.

II. Understanding Potential Systemic Risks and Access to Information about the Reinsurance Industry

As this Subcommittee is well aware, there is no federal entity with statutory authority or designated responsibility for oversight of insurance. There is also no committed expertise to advise Congress or the Administration on policy matters related to insurance or reinsurance.

Consequently, when an insurance issue arises, there is no source of information at the federal level to appropriately advise policymakers. As recent economic and natural catastrophe events suggest, the federal government has a strong interest in understanding this important market as it responds to these crises. At a minimum, there is a need for a federal entity that can utilize information and data from state regulators, but which is empowered to conduct its own analysis and provide advice based on a broader perspective than is driven by individual state interests. We believe Chairman Kanjorski's Office of Insurance Information legislation is good and timely, and goes a long way towards addressing this problem.

Reinsurance is an important part of the risk transfer mechanism of modern financial and insurance markets. Yet, there are clear distinctions between risk finance and management products that are relatively new financial tools developed in unregulated markets, and risk transfer products like reinsurance whose issuers are regulated by U.S. regulators or by their non-U.S. domiciliary regulator and whose business model has existed for centuries. In the case of reinsurance, regulatory reform is necessary to improve regulatory and market efficiency and maximize capacity in the U.S. That reform should address licensing, prudential regulation and international coordination and cooperation.

It has been suggested that the authority of a systemic risk regulator should encompass traditional regulatory roles and standards for capital, liquidity, risk management, collection of financial reports, examination authority, authority to take regulatory action as necessary and, if need be, regulatory action independent of any functional regulator. At a recent speech before the Council of Foreign Relations, for example, Federal Reserve Board Chairman Ben Bernanke acknowledged that such a systemic regulator should work as seamlessly as possible with other regulators, but that "simply relying on existing structures likely would be insufficient."

As I noted earlier in my testimony, the purpose of reinsurance regulation is primarily to ensure the collectability of reinsurance recoverables and reporting of financial information for use by regulators, insurers and investors. Because reinsurance is exclusively a sophisticated business-to-business relationship, reinsurance regulation should be focused on prudential or solvency regulation. We are concerned the systemic risk regulator envisioned by some—one without clear, delineated lines of federal authority and strong preemptive powers—would be redundant with the existing stated-based regulatory system. We also note that without reinsurance regulatory reform and a prudential federal reinsurance regulator, a federal systemic risk regulator would: (1) be an additional layer of regulation with limited added value; (2) create due process issues for applicable firms; and (3) be in regular conflict with the existing multi-state system of regulation.

III. International Developments, Coordination and Communication

The financial crisis of the last year demonstrated the importance of international coordination and communication across all financial services industries. Even before that, the 2008 U.S. Treasury's Blueprint for Financial Regulatory Reform ("the Treasury Blueprint") noted that the U.S. state-based insurance regulatory system creates increasing tensions in this global marketplace, both in the ability of U.S.-based firms to compete abroad and in the allowance of greater participation of foreign firms in the U.S. market. Foreign government officials have continued to raise issues associated with having at least 50 different U.S. insurance regulators, which makes coordination on international insurance issues difficult for foreign regulators and companies.

The Treasury Blueprint also noted that, while the NAIC attempts to facilitate communication among the states on international regulatory issues, it is not a regulator. The Blueprint further noted that because of the NAIC's status as a non-governmental coordinating body and the inherent patchwork nature of the state-based system, it will be increasingly difficult for the U.S. to speak effectively with one voice on international regulatory issues.

The time has already arrived where this lack of a single voice is adversely impacting U.S. reinsurers. The interaction between the U.S. and its foreign counterparts on issues like the European Union's Solvency II effort will likely impact not only the ability of U.S. companies to conduct business abroad, but also the flow of capital to the U.S. For U.S. reinsurers, Solvency II will set forth a process for determining which countries are "equivalent" for purposes of doing business in the European Union. Although this issue is still being discussed, the RAA understands the European Parliament obtained a legal opinion that stated that the European Commission cannot grant equivalence to a U.S. state under Solvency II. The possibility that the entire 50-state system in the U.S. will be deemed "equivalent" appears questionable, at best. Thus, without federal involvement by a knowledgeable entity tasked with responsibility for international policy issues, the U.S. reinsurance industry will continue to be disadvantaged in these equivalence discussions.

The United States also needs to be able to speak with one voice on international accounting issues. International consensus on this ongoing global project is central to the ability of the reinsurance industry to attract risk capital. The substance of these standards as part of a single, common global insurance accounting model is critical.

IV. Need for Authority to Recognize Foreign Supervisory Authorities

An informed federal voice with the authority to establish federal policy on international issues is critical not only to U.S. reinsurers, who do business globally and spread risk around the world, but also to foreign reinsurers, who play an important role in assuming risk in the U.S. marketplace. The current multi-state U.S. regulatory system is an anomaly in the global insurance regulatory world. Following the recent financial crisis, the rest of the world continues to work towards global regulatory harmonization and international standards. The U.S. is disadvantaged by the lack of a federal entity with Constitutional authority to make decisions for the country and to negotiate international insurance agreements. In the area of reinsurance, there is a need for a process for assessing the equivalence and recognition on a reciprocal basis of non-U.S. regulatory regimes. This process would assist non-U.S. reinsurers that supply significant reinsurance capacity to the U.S. insurance market by facilitating cross-border transactions through binding and enforceable international supervisory arrangements.

U.S. states impose a highly structured and conservative level of regulation on licensed reinsurers. However, it has long been recognized that there are several globally-recognized methods of conducting reinsurance regulation.

The RAA was encouraged by the inclusion of a system of supervisory recognition among countries in "The National Insurance Act of 2008" (S. 40), introduced during the last Congress. Supervisory recognition seeks to establish a system where a country recognizes the reinsurance regulatory system of other countries and allows reinsurers to conduct business based on the regulatory requirements of its home jurisdiction. If such a system were established, non-U.S. domiciled reinsurers would be permitted, for example, to assume reinsurance risk from the U.S. on the basis of regulation in their home country. In return, such a system would allow U.S. reinsurers to conduct business in that market or country, based on U.S. regulatory oversight.

A single national regulator with federal statutory authority could negotiate an agreement with the regulatory systems of foreign jurisdictions that can achieve a level of regulatory standards, enforcement, trust, and confidence with their counterparts in the U.S.

V. <u>Financial Services Regulatory Modernization</u>

Most, if not all participants in the dialogue about financial services modernization, acknowledge that most financial markets are global and interconnected. Federal Reserve Board

Chairman Bernanke noted that the global nature of finance makes it abundantly clear that any reform in the financial services sector must be coordinated internationally. Among the financial services providers, no sector is more global in nature than reinsurance. Even the NAIC has acknowledged that "in light of the evolving international marketplace, the time is ripe to consider the question of whether a different type of regulatory framework for reinsurance in the U.S. is warranted."

As Congress proceeds with financial services modernization, we emphasize the global nature of reinsurance, the utilization by reinsurers of both U.S. and non-U.S. holding company structures, the exclusive focus of reinsurance regulation on prudential oversight (i.e., no rate and form regulation or consumer element) and that only the federal government currently has the requisite Constitutional authority, functional agencies and experience in matters of foreign trade to easily modernize reinsurance regulation. Multi-state regulatory agencies in matters of international trade are at best inefficient, pose barriers to global reinsurance transactions, and do not result in greater transparency.

The RAA recommends that reinsurance regulatory modernization be included in any meaningful and comprehensive financial services reform through the creation of a federal regulator that would have exclusive regulatory authority over reinsurers that obtain a federal charter and make clear that there is no redundancy with state regulation. We recommend further that any such financial reform incorporate authority for a system of regulatory recognition to facilitate cooperation and enforcement with foreign insurance regulators.

VI. Conclusion

The RAA thanks Chairman Kanjorski, Ranking Member Garrett and the Subcommittee for this opportunity to comment on the reinsurance industry's perspective on systemic risk, how to improve oversight of the reinsurance industry and how to restructure the federal government's role with regard to reinsurance We look forward to working with all Members of the House Financial Services Committee as it considers these important issues.