Senate Fiscal Agency
P. O. Box 30036
Lansing, Michigan 48909-7536

SFA BILL ANALYSIS

Telephone: (517) 373-5383
Fax: (517) 373-1986
TDD: (517) 373-0543

Senate Bill 1219 (as enrolled)
Sponsor: Senator Bill Bullard, Jr.
Senate Committee: Financial Services
House Committee: Insurance and Financial Services

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RATIONALE

In order to increase an insurer's capacity to underwrite large individual policies, insurance company regulators often allow domestic insurers to reinsure (or cede) some of their business with a financially responsible reinsurer and receive a reinsurance credit for that business. The reinsurance company assumes the risk for the portion of the coverage that the ceding insurer has contracted with it to cover. The ceding insurer than is able to take a credit against its outstanding liabilities for the reinsurance it cedes, and increase the volume of its business by accepting risks that otherwise would exceed its statutory limit.

Since Michigan law does not require companies to buy reinsurance only from domestic reinsurers, an insurer may purchase reinsurance from foreign or alien companies. As a result, Michigan has laws that permit a ceding insurer to receive reinsurance credit only if the reinsurer is subject to U.S. laws or has guaranteed its obligation to the ceding insurer. The National Association of Insurance Commissioners (NAIC) adopted model laws in 1984 and in 1991 to help states standardize requirements for reinsurance credits by allowing ceding insurers to take financial statement credit if the reinsurer was subject to U.S. regulatory laws or if the reinsurer had collateralized its obligations. Michigan's current law is modeled after the NAIC 1991 law.

According to the Office of Financial and Insurance Services (OFIS), U.S. regulatory agencies face occasional problems with alien reinsurance companies when they experience insolvencies and their assets are repatriated in their country of domicile under Section 304 of the U.S. Bankruptcy Code. This means that U.S. regulators may find themselves subject to a foreign country's laws when attempting to collect on a claim generated from a ceding insurer. According to the OFIS, U.S. regulatory agencies must standardize their reinsurance laws with regard to issuing reinsurance credits in order to protect domestic insurers from the hazards of insolvency when reinsuring through an alien reinsurance company. To address these problems, the NAIC adopted new provisions in 1996 that include substantive solvency regulations and clarifications. It was suggested that Michigan also adopt the updated provisions.

In addition, a "cut through" is an arrangement in which a reinsurance company pays a policyholder directly if the ceding insurance company becomes insolvent. According to the Reinsurance Association of America, a cut through was originated to assure mortgage lenders that the insurer writing a homeowners' policy could stand behind its obligations. The mortgage companies, and later the secondary mortgage markets, instituted rules requiring an insurer of a mortgaged home to meet certain financial standards or have a specified rating by an insurer rating service. Small insurers or new insurers often were shut out of the homeowners' market because they could not qualify. Reinsurers use a cut through to stand behind these insurers. If a reinsurer issues a cut through, it has a contractual obligation to pay the beneficiary of the cut through, but it also may have an obligation to pay the same proceeds to the receiver. Reportedly, 40 states allow credit for reinsurance if there is a cut through. It was suggested that cut through endorsements should be recognized and that reinsurers should be obligated to pay a claim only once.

CONTENT

The bill amended Chapter 11 (Reinsurance) of the Insurance Code to establish requirements and criteria for allowing a ceding insurer credit for reinsurance ceded; revise requirements for a trust fund for reinsurance ceded under reinsurance agreements for a group including incorporated and individual unincorporated underwriters; delete a provision that permitted the Commissioner of Financial and Insurance Services to allow credit that did not meet the Code's requirements; establish requirements in the trust agreement for reinsurance credit; and specify solvency provisions in a reinsurance

agreement.

Reinsurance Credit

Previously, credit for reinsurance was allowed only to the extent that the amounts recoverable were verified by the assuming insurer in statements filed with the Commissioner under the Code. The bill instead provides that for an assuming insurer that is licensed to transact insurance or reinsurance in this State or that meets the bill's requirements, credit is allowed only for cessions of those kinds or classes of business that the assuming insurer is licensed or otherwise permitted to write or assume in its state of domicile or, for a U.S. branch of an alien insurer, in the state through which it is entered and is licensed to transact insurance or reinsurance.

Under the bill, a ceding insurer is allowed credit for reinsurance ceded as either an asset or a reduction from liability on account of reinsurance ceded if the reinsurance is ceded to an assuming insurer that is accredited as a reinsurer in the State. Credit for reinsurance ceded is not allowed if the assuming insurer's accreditation has been revoked by the Commissioner after notice and a hearing. An accredited insurer is a reinsurer that meets all of the following conditions:

-- Files with the Commissioner evidence of the reinsurer's submission to the State's jurisdiction.
-- Submits to the State's authority to examine its books and records.
-- Is licensed to transact insurance or reinsurance in at least one state or, for a U.S. branch of an alien assuming insurer, is entered through and licensed to transact insurance or reinsurance in at least one state.

In addition, the accredited insurer must file annually with the Commissioner a copy of its annual statement filed with the insurance department of its state of domicile and a copy of its most recent audited financial statement, and must do one of the following:

-- Maintain a surplus as regards policyholders of $20 million or more, if its accreditation has not been denied by the Commissioner within 90 days of submission.
-- Maintain a surplus as regards policyholders of less than $20 million, if its accreditation has been approved by the Commissioner.

Trust Fund

Amount. Previously, credit was allowed when reinsurance was ceded to an assuming insurer that maintained a trust fund in a qualified U.S. financial institution for the payment of the valid claims of its U.S. policyholders and ceding insurers, their assigns, and successors in interest, and submitted to the Commissioner's authority to examine its books and records and bore the expense of the examination. The bill provides, instead, that a ceding insurer must be allowed credit for reinsurance ceded as either an asset or a reduction from liability on account of reinsurance ceded if the reinsurance is ceded to an assuming insurer that maintains a trust fund in a qualified U.S. financial institution for the payment of its U.S. ceding insurers, their assigns, and successors in interest, the trust agreement complies with requirements in the bill, and the assuming insurer submits to the Commissioner's examination authority and bears the expense of the examination.

Previously, in the case of a single assuming insurer, the trust had to consist of a trusteed account representing the assuming insurer's liabilities attributable to business written in the U.S., and the assuming insurer had to maintain a trusteed surplus of an amount sufficient to maintain compliance with Section 403 as respect to business written in the U.S. but not less than $20 million. The bill retains this provision but refers to reinsurance ceded by U.S. ceding insurers (rather than business written in the U.S.). (Under Section 403, a domestic, foreign, or alien insurer may not be, or continue to be, authorized to do business in this State if the insurer is not or does not continue to be safe, reliable, and entitled to public confidence.)

In the case of a group including incorporated and individual unincorporated underwriters, the trust previously had to consist of a trusteed account representing the group's liabilities attributable to business written in the U.S., and the group had to maintain a trusteed surplus of which an amount sufficient to maintain compliance with Section 403 but not less than $100 million had to be held jointly for the benefit of U.S. ceding insurers of any member of the group. The bill provides, instead, that the trust must consist of the following: a trusted account in an amount not less than the group's several liabilities attributable to business ceded by U.S. domiciled ceding insurers to any group member, for reinsurance ceded under reinsurance agreements with an inception date, amendment, or renewal date on or after August 1, 1995; or a trusted account in an amount not less than the group's several insurance and reinsurance liabilities attributable to business written in the United States, for reinsurance ceded under agreements with an inception date on or before July 31, 1995, and not amended or renewed after that date. In addition, the group must maintain a trusteed surplus as currently required.

The Code also required a group to make available to the Commissioner an annual certification of the solvency of each underwriter by the group's domiciliary regulator and its independent public accountant. The bill, instead, requires a group, within 90 days after its financial statements are due to be filed with the group's domiciliary regulator, to provide the Commissioner with an annual certification of the solvency of each underwriter member by the group's domiciliary regulator or, if certification is unavailable, financial statements prepared by independent public accountants for each underwriter group member.

In addition, the bill deleted the Code's provisions that addressed the case of a group of incorporated insurers under common administration that complied with the reporting requirements, had continuously transacted insurance business outside the United States for at least three years, and had aggregate policyholders' surplus of $10 billion. For this group, the trust had to be in an amount equal to the group's several liabilities attributable to business ceded by U.S. ceding insurers to any member of the group pursuant to reinsurance contracts issued in the name of the group. The group also had to maintain a joint trusted surplus of which an amount sufficient to maintain compliance with Section 403 as respects business written in the United States but not less than $100 million was held jointly for the benefit of U.S. ceding insurers of any member of the group as additional security for any liabilities.

The Code required that the trust be established in a form approved by the Commissioner. The bill specifies that the trust and any amendments to it must be established in a form approved by the commissioner of the state where the trust is domiciled or the commissioner of another state who under the trust instrument terms has accepted principal regulatory oversight of the trust.

Trust Agreement. Under the bill, the credit may not be allowed unless the assuming insurer agrees in the trust agreement to all of the following:

-- If the trust fund is inadequate because it contains an amount less than the amount required under the Code, or if the trust grantor has been declared or placed into receivership, rehabilitation, liquidation, or similar proceedings under the laws of its state or country of domicile, the trustee must comply with an order of the commissioner with regulatory oversight over the trust or with an order of a court of competent jurisdiction directing the trustee to transfer to the commissioner all of the assets of the trust fund.
-- The assets must be distributed by and claims must be filed with and valued by the commissioner with regulatory oversight pursuant to laws of the state in which the trust is domiciled that apply to the liquidation of domestic insurance companies.
-- If the commissioner with regulatory oversight determines that the trust fund assets or any part of the trust fund assets is not necessary to satisfy the claims of the U.S. ceding insurers of the trust grantor, the trust fund assets or any part of the trust fund assets must be returned by the commissioner to the trustee for distribution pursuant to the trust agreement.
-- The trust grantor waives any right otherwise available under U.S. laws inconsistent with the provisions above.

Noncomplying Reinsurance

Previously, the Commissioner could allow credit for reinsurance that did not otherwise meet the requirements of this section of the Code if the amount was not material to the ceding insurer's ability to meet the standards of Section 901 (which regulates insurers' loans and investments); the Commissioner was satisfied that the assuming insurers had met the requirements of Section 403; and the amounts were substantially confirmed in statements filed with the Commissioner under Section 438 (which requires insurers to file annual statements) or in similar statements filed in the assuming insurer's domiciliary jurisdiction and available to the Commissioner. The bill deleted this provision.

Insolvency

The bill specifies that a ceding insurer may not be allowed credit for reinsurance ceded as either an asset or a reduction from liability on account of reinsurance ceded, unless the reinsurance contract provides, in substance, that if the ceding insurer becomes insolvent, the reinsurance must be payable under the terms of the reinsurance contract by the assuming insurer on the basis of reported claims allowed by the liquidation court, without diminution because of the insolvency of the ceding insurer. The payments must be made directly to the ceding insurer or its domiciliary liquidator unless the reinsurance contract or an endorsement signed by the reinsurer to the policies reinsured requires the reinsurer to make payment to the payees under the policies reinsured if the ceding insurer becomes insolvent.

The reinsurance agreement may provide that the domiciliary liquidator of an insolvent ceding insurer must give written notice to the assuming insurer of the pendency of a claim against the ceding insurer on the contract reinsured within a reasonable time after the claim is filed in the liquidation proceeding.

If a life and health insurance guaranty association or its designated successor life or health insurer has assumed policy obligations as direct obligations of the insolvent ceding insurer and has succeeded to the rights of the insolvent insurer under the contract of reinsurance, then the reinsurer's liability must continue under the contract of reinsurance and must be payable under the direction of guaranty association or its designated successor. As a condition to succeeding to the insolvent insurer's rights under the contract, the guaranty association or successor life or health insurer must be responsible for premiums payable under the reinsurance contract for periods after the date of liquidation.

Under the Code, the amount recoverable by a liquidator from reinsurers must not be reduced as a result of delinquency proceedings, regardless of any provision in the reinsurance contract or other agreement. The bill also provides that the reinsurance must be payable pursuant to the terms of the reinsurance contract by the assuming insurer on the basis of reported claims allowed by the liquidation court, without diminution because of the insolvency of the ceding insurer.

Previously, payment made directly to an insured or other creditor could not diminish the reinsurer's obligation to the insurer's estate unless the reinsurance contract provided for direct coverage of a named insured and the payment was made in discharge of that obligation. Under the bill, payment made directly to an insured or other creditor may not diminish the reinsurer's obligation to the insurer's estate, unless the reinsurance contract or an endorsement signed by the reinsurer to the policies reinsured requires the reinsurer to make payment to the payees under the policies reinsured if the ceding insurer becomes insolvent.

<u>Statement of Legislative Intent</u>

The bill states that, "The legislature declares that the provisions of this amendatory act are fundamental to the business of insurance as provided in sections 1 and 2 of chapter 20, popularly known as the McCarran-Ferguson act, 59 Stat. 33 and 34... It is the intent of this amendatory act that upon the insolvency of an alien insurer or reinsurer that provides security to fund its United States obligations under the Insurance Code..., 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 under the insurance laws of the state where the trust is domiciled that are applicable to the liquidator of domestic United States insurance companies."

MCL 500.1101 et al.

ARGUMENTS

(Please note: The arguments contained in this analysis originate from sources outside the Senate Fiscal Agency. The Senate Fiscal Agency neither supports nor opposes legislation.)

Supporting Argument

The bill incorporates standardized provisions from the 1996 NAIC Credit for Reinsurance Model Act to provide more substantive solvency regulation and establish appropriate oversight and regulation of ceding insurers and reinsurance companies. The bill strengthens the State's position when dealing with domestic companies that cede business to alien reinsurers. The bill also reinforces State actions to require security from non-U.S. reinsurers, enforces State requirements that the claims against insolvent non-U.S. insurers be paid according to State law, and ensures Michigan's ability to assert its rights to control alien company collateral in order to prevent it from being repatriated under Section 304 of the U.S. Bankruptcy Code.

Response: The bill does not guarantee that the Commissioner will be able to control assets fully in the event of an alien reinsurance company's insolvency. Although the bill diminishes the problem of repatriation of an alien insurer's assets, the Federal courts could still preempt the McCarran-Ferguson Act (which leaves the regulation of the insurance business to the states), and order the U.S. claimants against a non-U.S. company to file their claims in the foreign country where the reinsurer is domiciled.

Supporting Argument

The bill eliminates confusing and ambiguous language by creating a uniform trust fund language for various classes of trusts, and makes consistent the regulatory authority over the trusts. Uniform language among regulatory agencies makes resolution of legal issues less time consuming and costly. The bill also brings State statutes governing Lloyd's of London reinsurance trust funds into conformity with the actual operation of the New York trusts as restructured by agreement between the New York Insurance Department and Lloyd's in 1995.

Supporting Argument

The bill protects policyholders who have signed a cut through agreement and assures that the funds held to pay claims remain under the control of the liquidator unless a document signed by the reinsurer provides otherwise. Since the reinsurer has direct knowledge of any endorsements added to the originally issued policies, the liquidator will not have to contact every policyholder to determine if a cut through arrangement exists. According to the OFIS, this language also protects reinsurers from having to pay the same claim to both the liquidator and the policyholder.

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This analysis was prepared by nonpartisan Senate staff for use by the Senate in its deliberations and does not constitute an official statement of legislative intent.

Legislative Analyst: N. Nagata

FISCAL IMPACT

The bill will have no fiscal impact on State or local government.

Fiscal Analyst: M. Tyszkiewicz