

NATIONAL CONFERENCE OF INSURANCE LEGISLATORS
INTERNATIONAL INSURANCE ISSUES COMMITTEE/EU-US DIALOGUE
WESTON, FLORIDA
FEBRUARY 24, 2006
MINUTES

The International Insurance Issues Committee/EU-US Dialogue of the National Conference of Insurance Legislators (NCOIL) met at the Bonaventure Resort & Golden Door Spa in Weston, Florida, on Friday, February 24, 2006, at 9:30 a.m.

Rep. Mark Young of Vermont, chair of the Committee, presided.

Other members of the Committee present were:

- Sen. Joe Crisco, CT
- Rep. George Keiser, ND
- Sen. Steven Geller, ND
- Sen. Bill Larkin, NY
- Assem. Nancy Calhoun, NY
- Assem. Ivan Lafayette, NY
- Rep. Gene Seaman, TX
- Del. Harvey Morgan, VA

Other legislators present were:

- Rep. Bill Sample, AR
- Sen. Pam Redfield, ND
- Rep. Pat Patterson, FL
- Rep. Duane Mutch, ND
- Rep. Frank Wald, ND
- Sen. Carroll Leavell, NM
- Sen. Alan Sanborn, MI
- Rep. Robert Godshall, PA
- Rep. Tony Melio, PA
- Sen. Neil Breslin, NY
- Rep. Kenny Bingham, SC
- Rep. Michael Reese, VT

Others present were:

- Susan Nolan, Nolan Associates, NCOIL Executive Director

MINUTES

Upon a motion made and seconded, the Committee voted unanimously to approve the minutes of its November 18, 2005, meeting in San Diego, California.

EU INDUSTRY PERSPECTIVE ON EU INITIATIVES

Suzanne Czech reported from her perspective as Head of International and European Single Market Affairs for the Comité des Assurances (CEA) on European Union (EU) initiatives relating to insurance. She said, by way of background, that the CEA is the European trade association of insurers and that its membership comprises 33 national associations. She said the CEA mission statement was to resolve issues of strategic interest to all European insurers, with a focus on regulation.

Ms. Czech said that the CEA at present has 33 members, comprising 30 full members, including 25 EU member states and five other markets (Iceland, Liechtenstein, Norway, Switzerland, and Turkey). She said it also has three associate members (Bulgaria, Croatia, and Romania), as well as observers (AISAM, Russia, and Ukraine). Ms. Czech said that members are not insurance companies, but national associations, and that the CEA is an umbrella federation, an association of associations.

Ms. Czech said that overall priorities for European insurers in 2006 include the Solvency II, International Financial Reporting Standards (IFRS), Financial Services Policy 2005-2010 and related white paper, Phase II of the insurance contracts valuation project, pensions and the role of insurance, the insurability of major new risks, and flood assessment management and prevention.

Ms. Czech said that the Financial Services Policy for the next five years, which is embedded in the above noted white paper, is the direct result of the EU financial services action plan set up in 1999. She said that the plan resulted in 42 measures that the European legislators had to adopt within the next five years.

Ms. Czech said that in 2005, the Commission wanted to take stock of the results. She said four working groups, including one for insurance, which included CEA participation, were set up to see if the plan had achieved its purposes. She said that each group drafted a report, and that the report relating to insurance stressed the importance of satisfactory implementation and enforcement of existing legislation; a regulatory pause (except legislation already in the pipeline); and systematic industry consultation and rigorous cost-benefit analysis for all initiatives.

Ms. Czech said that in response to the report, there has been a cessation of new legislation with exception of legislation in the pipeline, a focus on the need for consolidation of financial services and appropriate implementation of the existing legislation on the national level, and an acknowledgment of the importance of industry consultation.

Ms. Czech said the Commission started to be criticized by market participants for overregulation, for provisions that are not necessary or not bringing the expected benefits, for inconsistencies or overlaps in regulation. She said the Commission responded to the criticisms by going back to the EU member states and asking them to review their implementation of the directives, stressing that member states should avoid “gold plating,” adding layers and layers of provisions to directives.

Ms. Czech said that the European Commission's main priority is dynamic consolidation of financial services, including

- better regulation (consultation, impact assessment, appropriate implementation & enforcement, simplification)
- improved EU regulatory and supervisory structures (clarify the home-host responsibilities, improve the efficiency of supervision, increase consistency and timeliness of cooperation of supervisors)
- ongoing and future legislative activities, such as Solvency II, insurance guarantee schemes, etc.
- broadening of its external dimension (EU-US dialogue, successful GATS negotiations, widening of dialogue with countries such as China, India, Russia and Japan)

Regarding finite reinsurance, Ms. Czech said that a CEA, the American Insurance Association, the American Council of Life Insurers, the National Association of Mutual Insurance Companies, and the Reinsurance Association of America together sent a letter to the International Association of Insurance Supervisors (IAIS) in October 2005 regarding the issue, stating that the industry favors a principles-based, non-prescriptive approach to the regulation of finite reinsurance. She said that the EU Reinsurance Directive contains a principles-based definition of finite reinsurance.

Ms. Czech said that CEA advocates for further developments in WTO negotiations. She said that CEA communicates on a regular basis to the European Commission the wishes of its members for full liberalisation of the insurance and reinsurance sectors of key developing markets, including Brazil, India, China, etc.

Rep. Young said that the EU is experiencing the same issues that the US is, including pensions and long-term care, cost-benefit analysis of regulation, overregulation concerns, simplification, and guarantee schemes, etc. He said there is much to be gained by a dialogue between the US and the EU.

BERMUDA INTERNATIONAL COMMERCIAL AND REINSURANCE CARRIERS

Bradley Kading, president & executive director of the Association of Bermuda Insurers and Reinsurers (ABIR) reported on Bermuda's commercial and reinsurance marketplace.

By way of background, Mr. Kading said that ABIR comprised 18 Class Four companies that are highly capitalized and are under distinct regulation. He said that Class Four regulator distinctions include

- highest capital requirement
- a more stringent solvency margin requirement
- disclosure of ceded reinsurance
- additional financial reporting tied to loss of capital

- restrictions on large dividend distributions
- requirement of an affidavit stating standards can still be met if capital is reduced

Mr. Kading said that ABIR companies are located in Bermuda, with operating subsidiaries in the US and Europe. He said the companies are worldwide business enterprises, with 1,500 employees in Bermuda and 10,000 worldwide. He said ABIR members include Ace, Allied World, Arch, Aspen, Axis, Catlin, Endurance, Hiscox, IPC Re, Max Re, Montpelier, Olympus Re, Partner Re, Platinum, PXRe, Quanta, Renaissance Re, and XL Capital.

Mr. Kading said that Bermuda reinsurers in 2004 comprised 13 of the top 40 ranked by Standard and Poor's (S & P), with more than either Europe or the US; and 7 of the top 20 property-casualty reinsurers ranked by Benfield, and tied with Europe for the most reinsurers in that ranking.

Mr. Kading said that ABIR statistics show member companies hold \$43 billion in premium volume, \$44 billion in surplus, \$50 billion in market capitalization, and 28 percent of S & P aggregate reinsurer surplus of \$160 billion.

Mr. Kading said that Bermuda carriers paid a good percentage of US catastrophe payments, including an estimated \$13 billion (26 percent of total payments) for 2005 hurricanes; an estimated \$4.5 billion (20 percent of total payments) for 2004 hurricanes; and an estimated \$2 billion (six percent of total payments) related to 2001 terrorist attacks.

Mr. Kading said that ABIR public policy objectives for the US include reinsurance regulation and property catastrophe issues. For Bermuda, he said, regulation and Class Four distinctions are objectives and for Europe, solvency and reinsurance regulation.

In response to a question from Rep. Keiser regarding the health of the reinsurance market, capacity, and a softening of the market, Mr. Kading said that Bermuda has raised \$18 or \$19 billion in capital in the last three months of 2005. He said that this amount is greater than the \$13 billion put forward by Bermuda reinsurers for the 2005 hurricanes. He said this capital provides an opportunity to grow and continue to market to additional business over time. He said the capital inflows are a sign of a healthy reinsurance market and that the Bermuda carriers have the respect of the capital markets and that this is the chosen method to deploy capital.

Mr. Kading said that the second type of capital coming in is hedge fund capital. He said that some of that is organized into what are called "side-car vehicles," which are basically dedicated retrocessional capacity. He said that retrocession as reinsurance for reinsurers is the truly hard market.

Mr. Kading said that hedge funds are now the major providers of retrocessional capacity. He said that people used to think that investors would come in through securitization instruments, but it's easier to come in as a reinsurer. He said that you can set up a dedicated pool from a hedge fund or other investment pool, e.g., \$300 million dollars, and enter into a reinsurance contract with a reinsurer. He said that through that simple transaction, the funds are collateralized not on a liability basis, but on a policy limits basis, the result being that those

reinsurers are getting retrocessional capacity on a dedicated policy limits basis. He said that this is the main way that retrocessional market needs are being met in the future.

Mr. Kading said that on a global basis, the hurricanes hit a number of carriers in Bermuda and Europe quite significantly. He said overall, capital has been quick to flow back to the business and it's clear that investors understand that outlier events which we've seen in the US over the last five years are events that must be expected from time to time; that carriers should not be punished for suffering a loss from those events; and that the market can be rebuilt and earn a profit over the long run. He said that such events tend to firm rates (cause the rates to increase) and that this cycle is virtuous, as the rates cause additional capital to flow into the business.

In response to a question from Rep. Keiser related to the future or absence of TRIA and the absolute level at which industry would require government backup, Mr. Kading said that the industry has two years to answer that question and that at present, it was not clear what the answer is. Mr. Kading said that within his membership, he has some carriers that do not want to write any terrorism risk, as well as a couple of carriers that specialize in terrorism risk and think that it is fundamentally under-writable. He said the real problem on insuring terrorism risk is the lack of data on frequency and severity of events and because of that, it takes a tremendous amount of capital to support any business that is written. He said that it would always be a challenge to find enough capital to support the risk coming out of major US metropolitan centers. He said that he had no answer to Rep. Keiser's question except to say that people are working on it, are cognizant of the deadline, and that entrepreneurs in the business are trying to figure out a solution.

IAIS/NAIC ACTIVITY

W. Ed Stephenson, staff to the Accounting Committee of the Group of North American Insurance Enterprises (GNAIE), summarized GNAIE's perspective of International Association of Insurance Supervisors (IAIS) and National Association of Insurance Commissioners (NAIC). He said that the IAIS is dealing with two major projects relating to insurance previously noted by Ms. Czech. He said that these include commenting to International Accounting Standards Board (IASB) on Phase II of IASB's insurance contracts valuation project and commenting on Solvency II and considering what parts of the initiative should be incorporated into a global standard for regulation.

Mr. Stephenson said that the IAIS is also looking at reactions to finite reinsurance issue in the US, discussions of catastrophe risk insurance, and developing projects on international standards in market conduct regulation.

Mr. Stephenson said that GNAIE was encouraged by NAIC participation in the process. He said that there commissioner participation at the IAIS level was good and commended Rob Esson, NAIC staffer, for his efforts in chairing the IAIS accounting committee. He said that his group would like to encourage NCOIL to support those efforts going forward and to encourage greater participation by insurance regulators. He said that GNAIE views the issues as incredibly important and IAIS is an important and appropriate forum to address the issues.

Mr. Eric Nordman, director of research for the NAIC, reported that the NAIC will discuss international issues at its next meeting on March 3, during the spring national meeting. He said that the NAIC has created a new International Solvency Initiatives Working Group to take up issues such as those that had been noted previously.

Mr. Nordman said that one issue that was not mentioned was a European Union dialogue on insurance groups. He said that the NAIC and some European regulators were working on a memorandum of understanding regarding this issue. He suggested that insurance legislators might want to get involved in that process.

Mr. Nordman said that discussion of the NAIC reinsurance collateral white paper will also be addressed at the NAIC spring meeting. He said that this issue, as legislators know, has been quite controversial.

Mr. Nordman reported that the IAIS has faced increasing challenges with its work structure and particularly resources. He said that the IAIS tends to be dedicated to the education and training of its members, in order to develop expertise in insurance supervision in development and delivery of training programs, while encouraging partnerships in education providers to handle some of the logistics and structures there. He said that this reshifting in work will help the IAIS more closely work on settlement of international regulatory standards, rather than the education and training.

Mr. Nordman said that the EU is also very interested in what's going on in the US related to terrorism risk, natural catastrophe risk, including flooding, and asbestos liabilities.

Rep. Young said the reinsurance collateral issue is of great interest to NCOIL and that NCOIL would be following the NAIC efforts, including the reinsurance collateral white paper. He said that he had recently met with Commissioner McCreevy, Commissioner for Internal Market and services of the EU Commission. He said that he hoped that the NAIC would move forward with the issue, one way or another. He said that while Commissioner McCreevy had not pushed for an immediate answer, he had expressed the Commission's desire to at least see a schedule or plan to work through the issue.

INTERNATIONAL ACCOUNTING & SOLVENCY STANDARDS

Mr. Stephenson then spoke regarding international accounting and solvency issues. He expressed GNAIE's continuing concern over the International Accounting Standards Board's (IASB) direction on decisions on key elements of the insurance contract project that are being taken up by the board in the next two months. He said the decisions are leading to requirements for "fair value" of liabilities, use of risk margins, discounting of reserves for all contracts, and contract unit of account. He said these provisions may require unbundling and recognition of gain at inception.

Mr. Stephenson said that the Financial Accounting Standards Board (FASB) risk transfer is an outgrowth of the "finite re" controversy. (*FASB is the designated private sector organization in the US that establishes financial accounting and reporting.*) He said that FASB is seeking a

standard on when a contract transfers risk. He said this will probably lead to a definition of insurance and may be extended beyond reinsurance to direct lines. He reported that the board is currently leaning toward requiring bifurcation.

Mr. Stephenson said that international solvency initiatives grow out of Basel II for banking. He said that the “Solvency II” initiative of the EU, aimed at harmonizing the solvency regulations of financial institutions including insurance, comprised three “pillars,” addressing

- financial resources, including capital adequacy
- regulatory supervision, including management, risk assessment and internal controls
- market discipline, including disclosure and transparency to customers and investors

Mr. Stephenson said that most countries don’t have separate statutory and generally accepted accounting principles (GAAP) so accounting and solvency are more connected overseas. He said that the NAIC has initiatives like principle-based reserving and risk assessment examinations that smell like Solvency II, but until very recently, there has been little coordination.

Mr. Stephenson said that these issues are important to the US because of convergence pressure. He said the playing field includes state to state, large to small, US to alien, and competition for investors and customers.

He said that legislators need to encourage individual insurance commissioners and the National Association of Insurance Commissioners (NAIC) as the entity that is engaged in this international debate to be proactive rather than reactive and to think globally and act locally.

EU REINSURANCE DIRECTIVE AND IMPLICATIONS ON FINITE REINSURANCE

Reinhard Elers, senior vice president of Hannover Re Advanced Solutions, spoke to EU reinsurance initiatives and how they impact finite reinsurance. He reported that the EU Reinsurance Directive was signed into legislation on December 2005. He said it provides a framework for individual member state regulation, to be implemented within two years.

Mr. Elers said that Article 45 of the directive is explicit about finite reinsurance, by providing a definition, as follows: “Reinsurance under which the explicit maximum loss potential, expressed as the maximum economic risk transferred, arising both from a significant underwriting risk and timing risk transfer, exceeds the premium over the lifetime of the contract by a limited but significant amount, together with at least one of the following two features:

- explicit and material consideration of the time value of money
- contractual provisions to moderate the balance of economic experience between the parties over time to achieve the target risk transfer

Mr. Elers said that Article 45 allows member states to lay down specific provisions concerning the pursuit of finite reinsurance activities regarding

- mandatory contract conditions
- administrative and accounting procedures, adequate internal control mechanisms
- accounting, prudential and statistical information requirements

- technical provisions to ensure that they are adequate
- investments of covering assets
- rules relating to solvency margins and requirements

Mr. Elers said that potential pitfalls related to the implementation of Article 45 of the reinsurance directive include the risk that individual member states

- develop their own, diverging definitions of finite reinsurance and significance of risk transfer
- may resort to special ‘rules based’ regulation
- insist on mandatory contract provisions, which may conflict with mandatory provisions for other, non-EU based business partners
- create a further class of contracts which is not aligned with existing (and developing) accounting classifications

He said member states should instead

- maintain a principle-based approach
- emphasize transparency and adequate controls
- assure harmonized implementation within the EU, and beyond

Mr. Elers said that a quantitative separation between traditional and finite reinsurance is of no value. He said there needs to be an identical borderline for regulatory and accounting purposes. He recommended that in order to facilitate and encourage the use of finite reinsurance as a legitimate and cost-efficient tool to manage insurance risk, jurisdictions need to

- apply non-discretionary, actuarially sound metrics such as ERD to measure risk transfer
- avoid the creation of new ‘grey areas’ by implementing artificial product classes with specific rules
- strive for cohesion between regulatory and accounting guidelines
- be cautious towards total “fix-all” overhauls (such as ‘bifurcation’)
- focus on transparency and good governance / controls to combat willful misuse
- consider supportive comments even from ‘alien’ reinsurers, as the EU and US have a joint interest to maintain the reputation and integrity of our global industry on a worldwide basis

ADJOURNMENT

There being no further business, the Committee adjourned at 10:45 a.m.