

Client Alert

New NAIC Reinsurance Certification Requirements

Although the requirements of FASB 113 and SSAP 62 (related to GAAP and statutory reinsurance accounting and risk transfer) have been in effect since 1994, contracts that may or may not transfer sufficient risk to qualify for reinsurance accounting became front page news in 2005. Insurers and reinsurers are living in a new world when it comes to regulatory attention directed at “risk transfer” and, especially, “finite risk” business. As we write, insurers and reinsurers both in the United States and abroad continue to be the subjects of investigations by the SEC, by state Attorneys General and, of course, by state Insurance Departments. Whether or not allegations of abuses are valid, all insurers and reinsurers need to be familiar with the changing regulatory landscape. In this Client Alert, we summarize the requirements that will be implemented by the National Association of Insurance Commissioners (NAIC) for reporting by property and casualty companies in all 50 states in 2006 (i.e., for the 2005 reporting year). According to the NAIC, the new requirements will “improve transparency” and “clarify the overall impact of finite reinsurance on the industry.”

States Develop New Reporting Requirements for “Finite” Business

Following on the heels of federal and New York state investigations of finite reinsurance deals, Attorneys General and Insurance Commissioners in many states commenced their own investigations and introduced their own disclosure requirements.* The New York State Insurance Department (NYSID), for example, distributed Circular Letter No. 8 in March, 2005, requiring CEO attestation with respect to “cessions under any reinsurance contract” that there are no side agreements that would mitigate any parties’ loss under the reinsurance contract, and that there is “an underwriting file documenting the economic intent of the transaction and the risk transfer analysis evidencing proper accounting treatment.”

In an August 3, 2005 Supplement to Circular Letter No. 8, the NYSID discontinued these requirements in favor of the adoption by the NAIC of the requirements discussed below. However, Circular Letter No. 8 continues to apply to those property/casualty insurers who are subject to examination prior to filing their 2005 Annual Statements. CEOs of such companies will be faced with having to attest, “under penalty of perjury,” to the lack of “separate written or oral agreements that would under any circumstances, reduce, limit, mitigate or otherwise affect any actual or potential loss to the parties under the reinsurance contract” and to do so with respect to “cessions under any reinsurance contract.” Circular Letter No. 8 includes no limitation as to the characteristics or age of the contracts that are subject to these requirements. Similarly, the

* Overseas jurisdictions, including the European Union and the United Kingdom, are also increasing scrutiny of finite reinsurance and developing new disclosure requirements. Please contact us for additional information on these developments.

attestation respecting documentation of the economic intent and risk transfer analysis is not limited to any class or age of contract. For some companies, Circular Letter No. 8 will potentially sweep up hundreds of contracts, some of which may have been underwritten many years ago. Companies subject to examination prior to filing their 2005 Annual Statements may wish to consult with counsel regarding compliance with the CEO attestation requirement of Circular Letter No. 8. Companies domiciled or operating in states other than New York should check with their respective insurance departments for similar requirements.

The NAIC Steps In With New Interrogatories

A Working Group of the NAIC has adopted new disclosure requirements respecting risk transfer and finite risk business which will become operative for the 2005 Annual Statement. These include several new General Interrogatories as well as new attestation requirements. The interrogatories are intended to identify reinsurance agreements that have characteristics of contracts which the regulators have identified as prone to abuse and which may, therefore, warrant closer review by regulators. They apply only to “ceded” reinsurance. Under Interrogatory 9.1, the reporting company is asked to identify any ceded reinsurance which meets three conditions: (1) the agreement alters surplus by more than 3% (positive or negative) or represents more than 3% of premiums or losses; (2) the contract was accounted for as reinsurance and not as a deposit; and (3) the contract has one or more the following features “or other features that would have similar results”:

- non-cancelable contract terms longer than two years;
- a provision whereby cancellation triggers an obligation by the ceding company or an affiliate to enter into a new contract with the reinsurer or an affiliate;
- aggregate stop loss reinsurance coverage;
- an unconditional or unilateral right by either party to commute, unless triggered by a decline in the counter-party’s credit status;
- a provision permitting reporting or payment of losses less frequently than quarterly;
- payment schedule, accumulating retentions from multiple years or any features inherently designed to delay timing of cedent reimbursement (e.g., experience accounts).

In the event conditions 1, 2 and 3 are satisfied, the reporting company must provide certain supplemental information, namely: (a) a summary of the terms of the responsive contracts; (b) a brief discussion of the principal objectives and “economic purpose” for entering into the contract; and (c) the aggregate financial statement impact of all such contracts on the balance sheet and income statement.

A second interrogatory (9.2) is intended to capture additional potentially abusive reinsurance arrangements. Here, the reporting company must identify any ceded risks (other than to captives or under approved pooling arrangements) where (1) the ceded written premium is 50% or more of the entire direct and assumed premium written by the assuming reinsurer, based on its most recent financial statement; or (2) twenty-five percent or more of the written ceded premium has been retroceded back to the ceding company. Cessions by or to affiliates, including multiple contracts with the same reinsurer or its affiliates, are included in determining if the conditions are met. If either condition 1 or 2 of this interrogatory is met, the reporting company must provide the same supplemental information noted above.

An additional interrogatory (9.4) requires the ceding company to identify contracts which it has accounted for as reinsurance for statutory accounting purposes while accounting for it as a deposit for GAAP purposes (or vice versa). For any such contract, an explanation for the differing treatment must be provided in a supplemental filing.

CEOs and CFOs -- The New NAIC Certification Requirements

In addition to the new interrogatories (which will be part of “General Interrogatories” section of the Annual Statement), the NAIC will require beginning with the 2005 Annual Statement completion of a “Reinsurance Attestation Supplement” that is reminiscent of the provisions of the Sarbanes-Oxley Act. This is to be completed by March of each year by the CEO and the CFO, signed “under penalties of perjury,” and applies to “all reinsurance contracts for which the reporting entity is taking credit on its current financial statement.” Any exceptions must be disclosed and explained in the attestation. The attestation is to be made “to the best of their knowledge and belief after diligent inquiry” and has four parts:

(1) **No side agreements, written or oral, that would “under any circumstances, reduce, limit, mitigate or otherwise affect any actual or potential loss to the parties.”** This prong of the attestation applies to every reinsurance contract, and not just to those that may be characterized as “finite” in nature or appearance. Verifying the absence of all such oral and written arrangements as to all contracts will likely require both documentary review and interviews of underwriting personnel, perhaps even including prior employees. Companies should develop a plan for accomplishing this review and inquiry.

(2) **For reinsurance contracts entered into, renewed or amended after January 1, 1994, for which risk transfer is not reasonably considered to be self-evident, that there is documentation concerning the economic intent of the transaction as well as risk transfer analysis evidencing proper accounting treatment under SSAP 62.** Since neither FASB 113 or SSAP 62 applied prior to 1994, the NAIC recognizes that risk transfer analysis will not have been memorialized. In terms of which contracts have reasonably self-evident risk transfer, the ceding company may want to look back to the Interrogatories. Certainly, any contract reportable under the conditions delineated therein will be subject to this prong of the attestation. Companies will want to obtain guidance from counsel and auditors as to what constitutes sufficient “risk transfer analysis” in today’s environment.

(3) **The reporting entity complies with all requirements of SSAP 62.** This deceptively simple sounding prong will require the careful exercise of “due diligence.” Each company will determine, perhaps based on consultation with accountants, lawyers and independent auditors, what constitutes sufficient due diligence to establish compliance with all of the risk transfer and accounting requirements of SSAP 62.

(4) **The reporting entity has appropriate controls in place to monitor the use of reinsurance and adhere to the provisions of SSAP 62.** This prong is the key to the ability to make the CEO/CFO attestations on an ongoing basis. Some companies will have sufficient controls already in place; others will need to develop such controls and put them in place as soon as possible.

Living With The New Requirements

While perhaps slightly less demanding than the requirements of New York’s Circular Letter No. 8 -- which lacks the “best of their knowledge and belief” language and which seems to assume that

Chadbourne & Parke LLP

New York

30 Rockefeller Plaza
New York, New York 10112
Telephone: +1 (212) 408-5100
Facsimile: +1 (212) 541-5369

Los Angeles

350 South Grand Avenue, Suite 3300
Los Angeles, CA 90071
Telephone: +1 (213) 892-1000
Facsimile: +1 (213) 622-9865

London

Chadbourne & Parke
(a multinational partnership)
Regis House
45 King William Street
London EC4R 9AN
UK
Telephone: +44 (0)20 7337-8000
Facsimile: +44 (0)20 7337-8001

Warsaw

(through a Polish partnership)
ul. Emilii Plater 53
00-113 Warsaw
Poland
Telephone: +48 (22) 520-5000
Facsimile: +48 (22) 520-5001

Almaty

90 Shevchenko Street, 3rd Floor
Almaty 050022
Kazakhstan
Telephone: +7 (3272) 585-088
Facsimile: +7 (3272) 588-084

Washington, D.C.

1200 New Hampshire Avenue, N.W.
Washington, D.C. 20036
Telephone: +1 (202) 974-5600
Facsimile: +1 (202) 974-5602

Houston

1100 Louisiana, Suite 3500
Houston, TX 77002
Telephone: +1 (713) 571-5900
Facsimile: +1 (713) 571-5970

Moscow

52/5 Kosmodamianskaya Naberezhnaya
Moscow 115054
Russian Federation
Telephone: +7 (095) 974-2424
Facsimile: +7 (095) 974-2425

Kyiv

11 Mykhailivska Street, 4th Floor
Kyiv 01001
Ukraine
Telephone: +380 (44) 230-2534
Facsimile: +380 (44) 230-2535

Beijing

Room 902, Tower A, Beijing Fortune Centre
7 Dongsanhuan Zhonglu
Chaoyang District, Beijing 100020
China
Telephone: +86 (10) 6530-8846
Fax: +86 (10) 6530-8849

If you would like additional copies of this client alert, please contact Phillipa Yule, Director of Marketing and Creative Services, at +1 (212) 408-5240 or e-mail: pyule@chadbourne.com.