NEWSSTAND

To Secure or not to Secure When You Reinsure, That is the Question

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At least two factors have led cedents and reinsurers to reconsider traditional approaches to the collateralization of reinsurance obligations in the last twelve months. First, the global recession has adversely impacted the financial condition of most international financial services groups, including both reinsurers and banks which provide letters of credit to secure reinsurers' obligations. Second, after years of industry discussions, the New York State Insurance Department (NYSID)[1] and the National Association of Insurance Commissioners (NAIC)[2] have recently proposed modification of the US approach to credit for reinsurance that would loosen the requirement of 100% collateralization by unauthorized reinsurers.

In this environment, cedents should recognize that the risk of non-performance by well-rated reinsurers and banks is not insignificant. As AIG's spectacular descent from its place astride the global insurance industry to the ignominy of government ownership demonstrates, it may be difficult to assess accurately reinsurer default risk. At the same time, demand for letter of credit facilities has caused the cost of reinsurance to rise significantly, as a result of which reinsurers may be well-advised to develop alternative approaches to secure their reinsurance obligations to address the concerns of their cedents. Indeed, offering security to cedents in a cost-efficient way may provide reinsurers with a relative competitive advantage over those who do not.

While the adoption of proposals similar to those advanced by the NYSID and the NAIC may make reinsurance more available or less costly, US cedents in such a modified landscape may well face greater challenges in structuring reinsurance programs. When negotiating reinsurance treaties with unauthorized reinsurers from whom they can no longer demand full collateral as a regulatory requirement, will US cedents weigh the relative financial strength of reinsurers or overall exposure of the cedent to a particular reinsurer and seek levels of security above what would otherwise be required under US insurance law?

Downgrade Triggers

One approach to securing reinsurance obligations is for reinsurance contracts to include provisions that trigger collateralization in the event of reinsurer downgrades. However, experience with swap obligation collateralization triggers of the non-insurance operations of AIG and Lehman Brothers, among others, raises concerns as to whether such arrangements provide effective protection.

Indeed, cascading collateral triggers can lead to a "death spiral" of the counterparty, as in fact occurred in the UK with Independence Insurance, which slumped from an "A" rating to insolvency in a period of three months in 2001. Insureds with policies which contained downgrade triggers never obtained collateral. The possible limited efficacy of a collateralization trigger imposed on a downgraded reinsurer due to its deteriorating financial condition or liquidity constraints, may result in little practical benefit to an insurer.

Collateralization Options

Reinsurance obligations can be secured through "funds withheld" arrangements, pledges of cash or security, trust arrangements or letters of credit or other third party surety arrangements. Below we discuss some of the issues each of these solutions raises for cedents and reinsurers.

Funds Withheld

A funds withheld arrangement is the most favorable method of collateralizing reinsurance obligations from the perspective of a cedent. It may be unattractive to reinsurers due to the risk that insolvent cedents will not transfer earned ceded premiums or investment returns on the funds withheld. Simply crediting the funds withheld to a separate account in the name of the cedent will not provide security or priority to the reinsurer if the cedent becomes insolvent.

Whether or not it is practical for the cedent to provide security for its obligations to pay earned premium or income to the reinsurer will depend on the particular circumstances. However, a cedent must hold sufficient unrestricted assets to support the issue of a letter of credit, to pledge collateral or fund a collateral trust. To have to provide security for unpaid premium may more than offset the benefit of withholding funds for the cedent.

Security Interests

A reinsurer may be more interested in securing its reinsurance obligations through the pledge or charge of cash or securities of the reinsurer to the cedent. It should be noted that such arrangements are not an acceptable method of securing obligations of unauthorized reinsurers under current US credit for reinsurance rules. A pledge is accomplished through a charge over, or security interest in, a bank or securities account of the reinsurer which it grants in favor of the cedent.

If the pledged account is in the US, the parties will enter into an account control agreement with the bank or broker that opens the account. If the charged account is in the UK, this is normally addressed through a letter, acknowledged by the bank. The account control agreement or acknowledgement ensures that the cash or securities held in the pledged or charged account cannot be removed without the cedent's consent.

Additionally, the parties must negotiate their relative rights to the pledged or charged assets and interest earned, the investment criteria and discounts applicable in respect of the pledged or charged assets (referred to as "eligible collateral") and the circumstances that trigger the right of the cedent to take control of the pledged or charged assets, or for the reinsurer to withdraw some or all of the collateral.

Such negotiations may materially increase the time taken to negotiate the terms of the reinsurance and the frictional costs. It is probable that there will be different forms of agreement between a cedent and each of its reinsurers or a reinsurer and its cedents, since the market has no standard documentation and each agreement must be individually negotiated.

Non-Regulatory Trusts

We noted above that reinsurance obligations can be secured through a trust arrangement. Many industry participants are familiar with a so-called "Regulation 114 trust" (the name refers to the applicable New York regulation, but similar trusts are authorized under other US state insurance laws), which must include required provisions and permit unrestricted withdrawals by the cedent. Such trusts are unattractive to reinsurers since, like funds withheld, they do not provide any security to the reinsurer for payment of premiums if the cedent becomes insolvent, and allow cedents to withdraw funds at any time.

However, cedents and reinsurers can also negotiate trust arrangements to secure reinsurance obligations with a financial institution serving as trustee. Such a non-regulatory trust can circumscribe cedent withdrawal rights. Trustee fees may be relatively inexpensive and trustees can manage funds and administer distributions from the trust and substitutions of assets. As with pledged and charged accounts, there are costs associated with negotiating the trust arrangements. Unlike a pledge or charge, however, the distribution or release of funds is within the control of the trustee (rather than relying on the consent of the parties in accordance with the terms of the reinsurance contract) and resort to judicial intervention or commencement of enforcement proceedings is unlikely to be necessary.

Bank or Trustee Insolvency

An advantage to collateralizing reinsurance obligations through the pledge or charge of cash or securities or the deposit of assets in trust is that each approach eliminates reinsurer and cedent credit risk. However, cedents and reinsurers may instead be exposed to risk of the insolvency of the bank or broker that opens the charged or pledged account and of the bank or trust company that acts as a trustee. The instability of the global banking industry and growing government control of major financial institutions suggest that parties should monitor and investigate the condition of banks, brokers or trust companies involved in collateral arrangements. Legal advice should be taken on the structures available to mitigate the impact of insolvency of the bank or trustee.

Letters of Credit

Letters of credit have been extensively used by the insurance industry to support obligations. Unauthorized reinsurers can offer them in the US as alternatives to Regulation 114 trusts for credit for reinsurance purposes. However, as with Regulation 114 trusts, the form of such letters of credit is prescribed by law and cedent rights to draw upon the letter of credit are unlimited.

Letters of credit can also be effective in securing reinsurance obligations even when not required by law – they are the standard way of securing reinsurance obligations in Europe - and can be tailored to meet the specific needs of a cedent and reinsurer. However, letters of credit can generally be drawn on demand (notwithstanding the terms of the reinsurance) and are considerably more expensive than trust or pledge arrangements, since the bank is assuming personal liability for making payment to the cedent (which is not the case with a pledge, charge or trust arrangement).

In addition, over the last year, banks have become less willing to issue letters of credit on an unsecured basis and to issue multi-year or so-called "evergreen" letters of credit, unless mandated by regulation. Reinsurers are now likely to be required to post collateral with the bank issuing the letter of credit and have limited options as to eligible collateral. As with a pledge or trust, a cedent is exposed to the insolvency risk of the bank that issues the letter of credit, but would have the additional risk that the obligation of the bank under the letter of credit is an unsecured liability in relation to the cedent. Against that, the reinsurer carries the credit risk of the bank failing, since it remains liable to pay under the reinsurance. As with pledged and charged accounts, there may be structures available to mitigate this risk from the reinsurer's perspective.

Conclusion

Cedents and reinsurers have a number of options in determining whether to secure or not to secure reinsurance obligations. Other than in the context of collateralization required by regulation, the parties have great flexibility in structuring such arrangements.

Cedents should consider the financial condition of reinsurers and the cedent's aggregate exposure as an institution to each reinsurer. Reinsurers must weigh the costs of such arrangements and evaluate whether collateralization can distinguish them from competitors. Both cedents and reinsurers must take account of the previously unconsidered risk that banks which hold collateral or issue letters of credit may themselves fail.

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[1] "Proposed Tenth Amendment to Regulation No. 20 (11 NYCRR 125) Credit for Reinsurance from Unauthorized Reinsurers," released by the NYID on December 24, 2008. See our Client Advisory, "New York Releases Proposed Amendment to Regulation 20 Relaxing Collateral Requirements for Unauthorized Reinsurers and Prohibiting Arbitration" at www.eapdlaw.com.

[2] NAIC press release, December 7, 2008. See "NAIC Adopts Reinsurance Modernization Proposal", December 8, 2008, blog posting on www.InsureReinsure.com:
http://www.insurereinsure.com/BlogHome.aspx?entry=1212.