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California Department Holds Workshop On Draft Credit For Reinsurance Regulations

The California Department of Insurance (“CDI”) is currently in the process of promulgating “Reinsurance Accounting Regulations” (“RAR”). According to a recent Notice from the CDI, the regulations are authorized under California Insurance Code Sections (“CICS”):

- ♦ 720—Relating to issuance, suspension and revocation of certificates of authority;
- ♦ 739.9—Relating to Risk-based Capital;
- ♦ 922.8—Relating to credit for reinsurance;
- ♦ 923—Relating to filing of annual statements;
- ♦ 1215.8—Relating to the Insurance Holding Company System Regulatory Act; and
- ♦ 1781.12—Relating to Reinsurance Intermediaries.

The scope of the proposed RAR is far broader than the NAIC Model Credit for Reinsurance and Life Reinsurance Regulations, and the existing California rules on reinsurance found in the CDI’s Bulletin 97-5, which only cites CICS 922.8 as its basis of authority.

Pursuant to its rulemaking process, on September 27, 2004, the CDI conducted a workshop on a preliminary draft of the proposed regulation. Representatives of the insurance industry, including the RAA, the PCIAA, three reinsurance intermediaries, and a large California domestic property/casualty insurer testified as to concerns about numerous provisions of the preliminary draft. In addition to the testimony received on September 27, the CDI would consider written commentary received through the first week of October in developing its next draft of the RAR. The CDI’s time line notwithstanding, interested parties will have ample time to review the next version of the RAR and provide written or oral testimony. (see summary of the process at: <http://www.oal.ca.gov/document/HowToParticipate.pdf>). Although the draft RAR indicated a January 1, 2005 effective date, that was a typographical error, and the targeted effective date is actually January 1, 2006.

A common theme among those providing testimony at the workshop was California domestic ceding insurers (and, to a certain extent, insurers deemed commercially domiciled in California) would be competitively disadvantaged in the reinsurance market if the RAR is adopted as drafted. The concern is that reinsurers would, at a mini-

mum, charge California cedents more to meet the unique requirements of the RAR, and that certain reinsurers might not even provide covers at any price. Furthermore, industry testimony strongly noted that the RAR:

- ♦ Went beyond or conflicted with the accounting requirements found in NAIC Accounting Practices and Procedures SSAP 62;
- ♦ Would require insurers and reinsurers to discontinue common business practices traditional to the industry;
- ♦ Would tax the CDI’s resources; and
- ♦ Contained provisions which the CDI had no statutory authority to impose.

Lord, Bissell & Brook noted additional key differences between the CDI’s existing Bulletin 97-5 and the preliminary RAR proposal. The RAR:

- ♦ Covers not only credit for reinsurance accounting in financial statements, but also requirements for and restrictions upon agreement language, requirements for reinsurance intermediaries, and allowances for additional CDI oversight and possible approvals of reinsurance arrangements.
- ♦ Provides that credit for reinsurance will be automatically disallowed if the reinsurer has been placed under regulatory oversight by its domiciliary regulator because of financial hazard, if the risk transfer requirements prescribed in the regulation (which appear to differ in some ways from the risk transfer criteria found in the NAIC Accounting Practices and Procedures Manual) are not met, or if certain contract provisions do not comply with the RAR requirements.
- ♦ Expands and changes the criteria for an acceptable letter of credit to require 60-day notices under evergreen clauses, and to provide greater jurisdiction under the laws of California as to adjudication.
- ♦ Requires foreign ceding insurers to comply with California’s reinsurance accounting rules (while the CDI may not intend to exert extra-territorial jurisdiction with the RAR, most readers of the proposal have opined that this provision does just that).
- ♦ Includes Property and Casualty transfer of risk criteria that do not coincide with the cri-

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- ♦ Contains contract requirements for statement credit, including requirements that: 1) the contract or binding letter of intent be signed by the "as of" date of the financial statement (in case of a letter of intent, the full agreement must be executed within 90 days of execution of the letter of intent), 2) certain specific insolvency clause language found in CICS 922.2 must be included, and 3) any setoff clause shall not mention "insolvency."
- ♦ Prescribes specific language for inclusion in arbitration clauses, which would require parties to continue to meet their obligations under the agreement after filing for arbitration until a decision by the arbitration panel is rendered, and under certain circumstances would release a party from its obligation to arbitrate if the arbitration panel is not selected within 60 days or the hearing is not commenced within 180 days.
- ♦ Permits setoff provisions, but requires a specific listing of items subject to setoff, and prohibits language which would contractually "deem" credits and debits to be "mutual."
- ♦ Specifies that contract early termination provisions allow termination by a cedent with 30 days notice but with 90 days notice by an assuming company.
- ♦ Requires prior approval of cessions of 50 percent or more of an insurer's total liabilities, and provides that cessions of more than 90 percent of an insurer's total liabilities will only be approved for demonstrated financial need and for a limited contract period.
- ♦ Prohibits the entry into a reinsurance agreement that requires payments through a reinsurance intermediary unless the CDI has examined the intermediary and determined that payments through the intermediary pose "no undue risk to policyholders."
- ♦ Provides that if any recoverable from a reinsurer on paid losses is overdue by 90 days, all amounts due from the reinsurer on paid losses are not admitted, and, at the CDI's discretion, credits for other amounts due from the reinsurer may be denied.
- ♦ Provides that while the regulation will be effective for all new and renewal agreements effected on or after January 1, 2006, "all other

reinsurance transactions and any security provided thereon" shall conform to the regulation by January 1, 2007.

(The foregoing should not be construed as an exhaustive and detailed listing of differences.)

At this point, it appears that the RAR will primarily impact California domestic insurers and foreign insurers with a significant volume of California business (defined as commercially domiciled insurers by CICS 1215.13(a) or those insurers whose gross written premiums in California exceeds their written premiums in any other state). However, many interested parties believe that certain sections of the regulation may be interpreted as having significant extraterritorial application.

Lord, Bissell & Brook believes that the next draft of the RAR will be completed in January or

February of 2005, at which time the regulation, and the notices and statements of reasons required by the California Administrative Procedures Act, will be issued for public comment. The rulemaking process will then take another six to nine months.

If you believe your company is in the group potentially impacted by this regulation, you may review the current draft, which can be found on the CDI's Web site (<http://www.insurance.ca.gov/doc>). Click on "Legal Information," click on the "Proposed Regulations" link, and then enter "RH01015731" in Search Box). You may also be added to the CDI's mailing list for this regulation by contacting: Arlene Joyce, Senior Staff Counsel, California Department of Insurance, 45 Fremont Street, San Francisco, CA 94105, (415) 538-4424, Email: joycea@insurance.ca.gov.

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