REINSURANCE ASSOCIATION OF AMERICA
1301 Pennsylvania Avenue, N.W., Suite 900, Washington, D.C. 20004-1701

Telephone: (202) 638-3690
Facsimile: (202) 638-0936
http://www.reinsurance.org

April 23, 2009

Via E-mail

Commissioner Steven M. Goldman
New Jersey Department of Banking and Insurance
20 West State Street
P.O. Box 325
Trenton, NJ 08625-0325

Re: RAA Comments to March 24, 2009 Reinsurance Task Force Draft Reinsurance Regulatory Modernization Act

Dear Commissioner Goldman:

The RAA appreciates the opportunity to comment on the NAIC's March 24, 2009 draft Reinsurance Regulatory Modernization Act ("Draft Legislation"). We continue to support the NAIC's pursuit of comprehensive reinsurance regulatory reform and recognize that substantial progress has been made. Most importantly, we applaud the NAIC's recognition that federal tools are necessary to truly modernize reinsurance regulation and to implement its modernization proposal.

As drafted, however, the Draft Legislation has serious constitutional and organizational issues that must be corrected to implement the modernization proposal passed by the NAIC Plenary in December 2008. To provide comprehensive, meaningful reform of reinsurance regulation, the Draft Legislation must address the lack of uniformity and lack of authority to fully engage in the international arena that is inherent in the current 50-state system. Notably, the Draft Legislation grants the NAIC-created Reinsurance Supervision Review Board ("RSRB"), and the NAIC, national regulatory powers without federal oversight, raising significant constitutional roadblocks. The Draft Legislation also requires the enactment of NAIC model laws, through the onerous NAIC model law process, by Home State and Port of Entry Supervisors. Requiring states to adopt model laws to implement the objective of the proposal – single state regulation of reinsurers – is unnecessarily cumbersome and unworkable. If these fundamental constitutional and organizational issues are not dealt with, the Draft Legislation does not, and cannot, accomplish the Task Force's goal: comprehensive reinsurance regulatory reform.

Constitutional Issues

Pursuant to the U.S. Constitution, the federal government has limited and enumerated powers – meaning government institutions may exercise only the powers granted to them by the Constitution and only in the manner prescribed. Before a particular branch of government may delegate its given authority, certain standards designed to protect government institutions and the public must be followed. These standards for proper delegation are the subject of volumes of case law and commentary far beyond the scope of this letter. However, certain fundamental concepts of constitutional law are violated in the Draft Legislation. In particular, the Draft Legislation raises due process issues as well as concerns under the Appointments Clause and Tenth Amendment.

A. THE DRAFT LEGISLATION CONTAINS NO ENFORCEABLE DUE PROCESS

Due process of law derives from the Fifth and Fourteenth Amendments to the U.S. Constitution. The Fifth and Fourteenth Amendments' guarantees of due process are applicable to actions of the federal and state governments. Due process, in the context of the U.S. Constitution, refers to how and why laws are enforced. The Draft Legislation conflicts with the Fifth and Fourteenth Amendments to the U.S. Constitution as it contains no enforceable due process of law.

Typically, in the federal context, individuals would rely on the Administrative Procedure Act ("APA") for remedies in the event of adverse agency action. Without executive branch oversight, the RSRB is not subject to the APA.

The APA guarantees persons adversely affected or aggrieved by a federal agency action a right to judicial review. The Act was designed to achieve relative uniformity in the administrative machinery of the Federal Government. Without federal oversight and the corresponding protections of the APA, the Draft Legislation provides no meaningful check on RSRB action that may be arbitrary, capricious, an abuse of discretion, or otherwise not in accordance with law. The ability of the RSRB to operate virtually unfettered raises due process concerns making the current structure unworkable.

B. THE ESTABLISHMENT OF RSRB AS A PRIVATE ENTITY WITHOUT FEDERAL OVERSIGHT RAISES APPOINTMENTS CLAUSE ISSUES

Article II, Section 2, Clause 2 of the United States Constitution, known as the Appointments Clause, empowers the President of the United States (i.e., the Executive Branch) to appoint certain public officials with the "advice and consent" of the U.S. Senate. This clause also allows lower-level officials to be appointed without the advice and consent process. Significantly, Congress itself may not exercise the appointment power. The Appointments Clause thus functions as a restraint on Congress and as an important structural element in the separation of powers.

In this context, the relevant questions are whether the delegating institution has the enumerated power to execute the delegation and whether the receiving institution has the enumerated power to exercise the assigned authority. In reviewing the Draft Legislation, the NAIC should ask

whether it improperly delegates legislative and executive power to a private institution without federal oversight in violation of the Constitution. The answer is "yes."

The NAIC must evaluate whether the Draft Legislation creates an improper appointment by Congress. Pursuant to the Draft Legislation, the RSRB appears to act as a public official in many ways which require constitutional analysis, including evaluating both state and non-U.S. reinsurance supervisory systems, developing supervisory recognition agreements, and enforcing regulatory guidelines. Further, section 3 of the Draft Legislation explicitly states that the RSRB is a nonprofit corporation and not an agency or establishment of the government. This structure raises the question of whether the RSRB could properly exercise the authority granted, even if properly delegated. Without federal oversight, a grant of authority by Congress to the RSRB to exercise governmental authority is likely unconstitutional.

This delegation issue is particularly problematic in sections 2 and 6, where the RSRB is empowered to evaluate non-U.S. jurisdictions, develop supervisory recognition agreements and enter into regulatory cooperation agreements, because the ability to enter into lawful, enforceable recognition agreements is critical to the reinsurance industry. As a truly global business, increased cooperation with and recognition of non-U.S. regulatory authorities will greatly enhance reinsurers' ability to write reinsurance on a cross-border basis and more effectively manage their capital on a global basis. The NAIC must correct the constitutional shortcomings to have a viable vehicle for achieving these important objectives.

Finally, Section 9 of the Draft Legislation states that the RSRB shall coordinate with federal agencies. The constitutional issues raised above indicate that the RSRB should do more than merely cooperate and consult with federal agencies – a level of federal oversight is required.

C. THE DRAFT LEGISLATION COMPELS STATE ACTION IN VIOLATION OF THE TENTH AMENDMENT

The Draft Legislation also raises concerns regarding the Tenth Amendment of the Constitution. The Tenth Amendment provides that powers not granted to the federal government nor prohibited to the states are reserved to the states or the people. Although the Supreme Court rarely declares laws unconstitutional for violating the Tenth Amendment, the Court has done so where the federal government attempts to compel the states to enforce federal statutes.

In fact, two of the leading cases on the Tenth Amendment[1] clarify that Congress does not have the authority to command state action. Several provisions in sections 5 and 7 of the Draft Legislation direct state supervisors to take specific actions related to capital and surplus, financial statement treatment and security requirements. As structured, these attempts to compel state action are likely unconstitutional.

The RAA strongly recommends that the NAIC reevaluate how the RSRB is established as well as the prescriptive requirements on the states and make the necessary changes to ensure the Draft Legislation is constitutional. Specifically, the NAIC should revise the Draft Legislation to

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[1] *New York v. U.S.*, 505 U.S. 144 (1992); *Printz v. U.S.*, 521 U.S. 898 (1997).

ensure the establishment of the RSRB is done in a constitutionally permissible manner, including a provision for federal oversight. The NAIC should also examine and amend the process by which states are commanded to enforce the federal statutes.

NAIC Model Law Process

Section 5(a) provides that National Reinsurers will be supervised by a single state, their Home State supervisor, and Port of Entry Reinsurers will be certified to provide creditable reinsurance by a single state, their Port of Entry ("POE"). The section also requires that Home or POE states uniformly adopt model laws "established" by the NAIC. In reviewing the Draft Legislation as well as the December Framework Memorandum, it is unclear how many model laws will be necessary. If amendments to model laws are necessary, or new model laws need to be created, the NAIC is required to follow its model law process. The NAIC model law process is onerous and requires the parent committee and the Executive Committee to approve, by simple majority vote, the development of a model law before drafting begins. To be approved, the model law must involve a national standard that requires uniformity amongst all states and receive the commitment of significant regulator and association resources to educate, communicate and support its state implementation. Then, a drafting group must develop the model law within one year from the date of approval. Finally, a Model Law requires a minimum two-thirds majority vote of both the parent committee and the NAIC Executive/Plenary for approval. NAIC members are instructed to vote based on whether they will make a commitment to support the model law in their state. It is very difficult to imagine how the model law changes contemplated by the Draft Legislation will meet the approval requirements in the model law process. Since not every state will need or want to be a Home or POE state, there is no national standard requiring uniformity among the states – the federal enabling legislation is the vehicle for uniformity. Similarly, it does not seem likely such a model law would receive the commitment of support from a two-thirds majority of the NAIC if only a handful of states are needed as Home or POE states to effectively implement the proposal.

The requirement for Home and POE states to engage in the NAIC model law process will replicate the current issues in the state-based system. The recognition by the Reinsurance Task Force that federal implementing legislation was the most effective and efficient way to implement the modernization proposal was a significant step for the NAIC; inserting a model law requirement into the federal legislation is a step backwards. Instead, the legislation should be drafted so that the RSRB sets standards and evaluates Home and POE states with federal oversight, obviating the need for the NAIC model law process. The RAA recommends that the use of NAIC model laws in the Draft Legislation be eliminated.

Legislation Versus Regulation

The Draft Legislation leaves many details related to the operation of the RSRB to regulation. However, there are also many issues of a technical nature, particularly in Section 7, that are included in the legislation, which should more properly be dealt with via regulation. Section 7 defines specific criteria related to credit for reinsurance, collateral requirements and the assignment of ratings. To the extent these technical issues need to be revised as the regulatory system evolves over time, they should not be imbedded in federal law, but rather left to the

regulations that the RSRB is required to develop. Specific comments on the substance of the provisions of Section 7 are provided in the attachment to this letter. The RAA's recommendation in this regard, to leave the substance of section 7 to regulation, is dependent on the RSRB being lawfully constituted with federal oversight.

A list of section-by-section comments is included as an attachment to this letter.

We look forward to revised legislation that can provide meaningful comprehensive regulatory reform for reinsurance. We are available if you would like to discuss our comments further.

Sincerely yours,

Tracey Laws

cc: Dan Shelp
Ryan Couch
Bob Kasinow

Attachment

Attachment

Individual Section Comments

1. *Section 2(d):* The RSRB does not have the proper authority to adequately preserve the confidentiality of supervisory information it shares with non-U.S. supervisors. The RSRB must be subject to federal oversight to properly execute its functions, including the ability to preserve confidentiality.

2. *Section 3(b):* The use of the term succession is unclear and the subsection is unnecessary. The terms of corporate existence will be governed by the state of incorporation and the RAA recommends deleting 3(b).

3. *Section 4:* It is unclear what "transparent, publicly accountable entity" means in relation to a non-governmental entity. Consistent with the constitutional concerns articulated above, the RAA recommends the addition of federal oversight of the RSRB to the Draft Legislation to address Due Process concerns.

4. *Section 5(a):*

- The phrase "appropriate regulatory capacity" is unclear. The RAA recommends a change to the proposed legislation to indicate that it allows for "a State meeting RSRB developed and federally approved standards" to be the sole U.S. regulator … .
- Can Home State or POE supervisors be decertified by the RSRB?

5. *Section 5(b):*

- The word "laws" should be inserted before the word "resources" in the first sentence.
- The term "exclusive jurisdiction" is unclear and overbroad and should be clarified to say "exclusive regulatory jurisdiction."

6. *Section 5(b)(1):* The use of the phrase "qualified **small** states" is unclear. The RAA recommends deleting the word "small."

7. *Section 5(b)(2):* It is unclear whether the RSRB evaluates state reinsurance supervisory systems unilaterally or whether states will apply to the RSRB for evaluation?

8. *Section 5(b)(3):* The phrase "appropriate supervisory recognition approach" is unclear. Will the RSRB be considering "doing business" recognition as well as recognition for providing creditable reinsurance? Will all recognition agreements be uniform? What is the mechanism for resolving disputes related to supervisory recognition?

9. *Section 5(d):* The section does not adequately address issues of extraterritorial application of state laws. Currently some states apply their credit for reinsurance laws not just to domestic insurers, but on an extraterritorial basis to all licensed ceding insurers. The proposed legislation should specifically prohibit the extraterritorial application of states' credit for reinsurance laws.

10. *Section 6(d):* The section provides that the RSRB will establish fees to cover all RSRB costs. The section provides no further guidance on who pays the fees (companies or jurisdictions?), how RSRB costs will be allocated, or whether there are ongoing fees. Moreover, there must be federal oversight to ensure meaningful review of the RSRB fee setting process.

11. *Section 7:* As indicated in our letter, the RAA believes the substance of Section 7 is better left to regulation. The following comments apply regardless of whether the provisions are included as part of the Draft Legislation or a regulations developed by the RSRB:

> *Section 7(c):* The list of factors to be considered by Home and POE state supervisors in section 7(c) are factors more properly considered during the process of evaluating a jurisdiction rather than during the determination of a rating. Consideration of these factors in determining the appropriate rating appears to be very vague and subjective. There should be an appeal process for reinsurers, and without the protections of the APA, it is unclear whether there will be a meaningful opportunity to appeal a rating determination by the RSRB.
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>> 7(c)(2) – This subparagraph provides the RSRB with unfettered discretion to mandate reinsurance contract clauses. This is a departure from the current NAIC model laws and accounting guidance, which require only a few specific contract clauses and do not dictate specific language. International regulatory practice follows the same approach. The departure from this custom puts the proposed legislation at odds with the way reinsurance is commonly transacted on a national and global basis. Reinsurance involves contracts between sophisticated entities and therefore the terms and conditions of reinsurance agreements should be left to the marketplace. The RAA strongly supports freedom to contract in a competitive market with respect to terms and conditions, other than those uniformly required by accounting guidance. There has been no rationale given for why mandatory contractual terms are necessary in a business-to-business transaction. We urge you to delete this requirement.
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>> 7(c)(3) – The phrase "business practices" is vague and overly subjective and the RAA recommends deleting this factor.
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>> 7(c)(6) – The phrase "reputation for prompt payment of claims" is vague and overly subjective and the RAA recommends deleting this factor. Further, there is no regulatory reason to separately address receivables payable to companies that are in administrative supervision or receivership. The NAIC Receivership and Insolvency Task Force is currently undertaking an examination of such receivables, but the inclusion of a specific project at a particular point in time is inappropriate in federal legislation.
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>> 7(c)(10) – The phrase "liquidation preference" is unclear and needs defining.

(7)(c)(11) – The subparagraph requires a vulnerable-5 rating for any reinsurer who participates in "any solvent scheme of arrangement, or similar procedure." First, it is unclear what is meant by "participates" – does this refer only to a company availing itself of a scheme or also to a company who involuntarily becomes subject to a scheme. Second, the draft should clarify that the evaluation is on a legal entity basis. A subsidiary reinsurer should not be punished for the participation by its parent or an affiliate in a procedure that may be perfectly legal, and even court sanctioned, in another jurisdiction.

Moreover, this provision is more appropriately included as a criterion for the RSRB to consider in vetting non-U.S. jurisdictions – whether the jurisdiction treats all stakeholders in runoff/insolvency situations as fairly as the U.S. This approach, especially with the "similar procedure" language, is subject to overly broad interpretations and is highly subjective and discretionary.

Section 7(f): The RAA strongly objects to Paragraph 7(f) which requires all reinsurers to post 100% collateral upon the entry of an order of rehabilitation, liquidation or conservation against the cedent. There is no direct correlation between ceding company insolvency and reinsurer financial difficulties. A highly-rated reinsurer that is meeting its obligations should not be required to collateralize its liabilities in this scenario because there is no increased credit risk. Also, the possibility that a reinsurer might have to post collateral in the event of the cedent's insolvency is not currently contemplated in the negotiating process. The NAIC should consider the ramifications of introducing this factor into the negotiation of reinsurance agreements.

To the extent that this provision requires a reinsurer to post collateral for IBNR, the RAA strongly opposes this provision based upon valuation and claims acceleration concerns. These unknown liabilities (IBNR) are actuarial estimates that insurers and reinsurers use for accounting purposes in order to ensure that sufficient funds will be available to pay for any claims which, in the future, may be reported, adjudicated and paid. Reinsurers are not required to pay, under their reinsurance contracts, on the basis of unknown potential losses in the form of IBNR. They are obligated to pay only known claims that have been fully identified, for which liability has been established and value has been determined. IBNR does not meet any of these requirements. At most the NAIC should consider requiring collateralization for known claims. The NAIC should also consider a neutral process for determining the appropriate amount of collateral. Because reinsurance is often the largest asset of an insolvent estate, placing collateralized funds within reach of a receiver presents opportunities for mischief in the face of pressure to maximize estate values.

In addition, the provision unfairly penalizes a reinsurer for the insolvency of its cedent by forcing the posting of 100% collateral when such posting may not be contractually mandated and where the cedent's insolvency is no fault of the reinsurer. A.M. Best's special report on insolvency (*Best's Insolvency Study, Property/Casualty U.S. Insurers*, 1969-2002) indicates that reinsurance failures are rarely the cause of ceding company insolvencies. Thus, there is no justification, from a solvency perspective, to require a

reinsurer to post collateral when a cedent is in financial difficulty. Cedent insolvencies usually arise from poor management of risk or poor underwriting results, and lead to significant claims which are ceded to reinsurers. To require collateral is to compound the problem for reinsurers.

Additionally, the reinsurers in this situation would be subject to either Home or POE state regulation either directly or through recognition arrangements. Where these reinsurers are timely meeting payment obligations, they should not be required to bear the additional costs of collateral and other associated risks. Where they are not, the Home or POE regulator has regulatory options to deal with the situation.

12. *Section 8:* The section provides no mechanism for resolving disputes related to the scope of preemption. It is highly likely disputes will arise related to state action in light of the new federal law. The Draft Legislation should provide a clear mechanism for resolving such disputes (and other disputes related to enforcement of the provisions of the Draft Legislation) or risk appearing weak.