

MARKET BULLETIN

REF: Y3986

Title	California Credit for Reinsurance Regulations: further guidance
Purpose	To provide further guidance on recent changes to the California Credit for Reinsurance law, effective 1 January, 2007.
Type	Event
From	James Walmsley, Senior Manager, Lloyd's International Market Access (extension 5131)
Date	23 March 2007
Deadline	The Regulations were effective 1 January 2007
Related links	Lloyd's market bulletin Y3900 dated 3 November, 2006 California Reinsurance Oversight Regulations

Purpose of bulletin

To provide further guidance on recent changes to the California Credit for Reinsurance law, effective 1 January, 2007.

Background

Lloyd's issued Market Bulletin Y3900 entitled "California: Credit for Reinsurance Regulations" on 3 November 2006. The Bulletin can be found by [clicking here](#) and provides a summary of the Regulations.

Since that Bulletin was issued, there have been requests for clarification on how the Regulations affect the underwriting of California reinsurances. This Bulletin therefore focuses on provisions of particular relevance to reinsurers and does not provide a detailed summary of all the Regulations. Anyone requiring further details should consult the original text of the Regulations or seek professional legal advice

The Regulations

The California Department of Insurance (“CDI”) has adopted a modified version of its general revision of the rules governing reinsurance in California¹. These Regulations, which are generally referred to as the “Reinsurance Oversight Regulations”, reflect a rewrite of California’s reinsurance rules on accounting for reinsurance on financial statements, including credit for reinsurance, general requirements for reinsurance agreements and the oversight of those matters by CDI.

The full text of the Regulations can be viewed [here](#), and can be found at the following address - <http://www20.insurance.ca.gov/epubacc/REG/89540.htm>.

Impact of Regulations on Underwriters at Lloyd’s

The Regulations include changes to security provided under accredited reinsurer status, multiple beneficiary trusts established by non-US reinsurers, and under letters of credit. These changes may therefore be applicable to Underwriters at Lloyd’s assuming risks from California domestic and foreign ceding insurers (the California Department of Insurance (CDI) continues to reserve the right to apply its credit for reinsurance rules to all California licensed ceding insurers, not just California domestics).

A summary of these changes is attached at Appendix A. Underwriters at Lloyd’s accredited status in all U.S. states are responsive to individual state’s credit for reinsurance regulations, which, with very few exceptions, have adopted the NAIC Credit for Reinsurance Model Law.

Further information

If you have any queries about this market bulletin, please contact Lloyd’s International Trading Advice:

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¹ The new rules appear at California Regulations Title 10, Chapter 5, Subchapter 3, Article 3, §§2302 through 2303.25 and are entitled: “Reinsurance Accounting, Agreements and Oversight”.

The California Regulations: A summary of significant provisions for Lloyd's

Definitions of insurers

The Regulations define three categories of ceding insurers. As these are categories of California licensed insurers these definitions do not apply to Lloyd's and Lloyd's syndicates. The three categories are as follows:

- **Domestic insurer:** a licensed insurer domiciled in California.
- **Foreign insurer:** a licensed insurer domiciled in another US state.
- **Volume insurer:** a foreign insurer whose average gross direct premiums written in California as reported in its three most recent annual statements (a) exceeds the average gross direct premiums written in its state of domicile for the same period, and (b) constitutes 33 percent or more of its total gross direct premiums written in the United States for the period.

Taking credit for reinsurances placed with Lloyd's

An insurer licensed in California can take balance sheet credit for a reinsurance contract with Lloyd's underwriters under section 2303.5 of the Regulations. 2303.5(a) states:

"Credit on financial statements shall be allowed for reinsurance ceded to an assuming insurer that, as of any date on which statutory financial statement credit for reinsurance is claimed and thereafter for so long as credit for reinsurance is claimed, maintains an approved U.S. trust as security for the payment of the valid claims of its U.S. domiciled ceding insurers, their assigns and successors in interest..."

Lloyd's syndicate Credit for Reinsurance Trust Funds, supported by Lloyd's Credit for Reinsurance Joint Asset Trust Fund, meet the requirements of this section.

Section 2303.5 contains detailed filing requirements. Lloyd's will take steps to meet these requirements centrally: unless subsequent guidance is provided there is no need for managing agents to take action.

Trust fund investment requirements

Section 2303.5(e) sets out the types of asset that may be deposited in a US trust. This is similar to the NAIC Model Regulation on the same subject, except that it limits letters of credit to 20% of the assets in the trust. This restriction on letters of credit will apply to Lloyd's at an aggregate market level.

Taking credit for reinsurances – security provided by letter of credit

Reinsurances are sometimes arranged where the security is provided by putting up a letter of credit outside a syndicate CRTF. The California Regulations permit an insurer to take credit for such reinsurance, and largely follow the NAIC Model Act and Regulation.

Additional requirements under the Regulations in section 2303.8 include the following:

- A letter of credit must provide that, except where the amount of the letter of credit is increased, the letter of credit cannot be modified without the prior written consent of the beneficiary.
- The Regulations require that the letter of credit provide that the obligation of the issuing or confirming bank is not contingent upon reimbursement or its ability to perfect a lien or obtain a security interest.
- The Regulations require that the bank issuing the letter of credit give notice of non-renewal at least 60 days prior to expiration and require that the notice be given by registered or certified mail, return receipt requested, or by overnight courier service, signature upon delivery required.
- The Regulations require that the letter of credit provide at least 60 days additional time to draw against the letter of credit once the issuing bank resumes business following certain business interruptions.
- The Regulations require that if the letter of credit is more than one page, each page must identify the issuing bank and credit number

A form of letter of credit that meets these requirements for domestic insurers is attached to the Regulations as Form AR-3 (09/05). Alternative forms of letters of credit may be submitted to the CDI for a written determination that they meet the Regulations.

Transfer of Risk Rules

Section 2303.12 of the Regulations states that, for property and casualty insurance, transfer of risk will be determined by application of NAIC Accounting Guidance's risk transfer requirements (these requirements appear in the NAIC Accounting Practice and Procedures Manual and the NAIC annual statement blanks and instructions). If the CDI reviews a reinsurance agreement to determine transfer of risk, it may review all contracts between the ceding insurer, the reinsurer and their respective affiliates to evaluate contractual features that may (1) limit the amount of insurance risk to which the reinsurer is subject under the agreement, or (2) delay the timely reimbursement of claims by the reinsurer.

Section 2303.11 contains detailed requirements concerning the transfer of risk for the reinsurance of life and disability insurance. These requirements have not been summarised here, but should be consulted by anyone involved in the transaction of this business.

Contract Requirements

The Regulations contain requirements that a reinsurance contract must comply with. These requirements are in two sections:

2303.13 – The reinsurance contract must meet these conditions, if the ceding insurer is to take credit for the reinsurance.

The Agreement must:

1) If it is property or casualty insurance, expressly state that it constitutes the entire agreement, except for separate contracts expressly disclosed. This does not apply to reinsurance of individual risks pursuant to facultative certificates issued by the reinsurer.

2) Contain an acceptable insolvency clause.

For a domestic insurer, the insolvency clause must comply with the California Insurance Code Section 922.2(a)(2). A copy of these provisions is set out in full in appendix B.

For a foreign insurer, separate requirements are set out in the section, but these are substantially the same as those for domestic insurers set out in s. 922.2(a)(2).

3) Meet the credit for reinsurance requirements of the NAIC Accounting Guidance.

2303.14 – The failure to follow a requirement in this section does not result in a denial of statement credit, but rather a determination that the reinsurance contract is deficient as to form².

1) If the Agreement contains an "early termination clause", this must comply with the following requirements.

- A. The basis for termination may not include the entry of an order of rehabilitation, conservation or liquidation against the ceding insurer.
- B. The provision shall require written notice to the ceding insurer of not less than sixty (60) days prior to the effective date of termination,
- C. The provision shall require signature upon delivery of the notice and may specify procedures to establish proof of attempted service if signature is refused.
- D. The provision may state that upon receipt of a notice sent by the reinsurer, the ceding insurer may consent to a lesser notice period.
- E. The provision may state that it shall not be construed to include termination of the contract for cause.

2) If the Agreement provides for payments between the parties to be transmitted through an intermediary, the contract must contain the following clause:

"Payments by [the ceding insurer] to the intermediary shall be deemed to constitute payment to (the reinsurer). Payments by (the reinsurer) to the intermediary shall be

² One or more reinsurance contracts that are deficient as to form may be sufficient to support a finding that the insurer's reinsurance arrangements are materially deficient.

deemed to constitute payment to (the ceding insurer] only to the extent that such payments are actually received by (the ceding insurer]."

Reinsurance of individual risks pursuant to facultative certificates issued by the reinsurer are not required to comply with these two provisions.

Oversight of Reinsurance Transactions

The Regulations establish rules for regulatory oversight of certain reinsurance transactions:

- The failure of a domestic or volume insurer to retain at least 10% of direct premium written per line of business (except for cessions to affiliates) may be grounds for a finding that the insurer's reinsurance arrangements are materially deficient for purposes of California Insurance Code §717(d). The Commissioner may consent to a lesser percentage of retained risk upon demonstrated business necessity.
- A foreign insurer requires Commissioner consent to transfer or attempt to transfer substantially the entire property or business of the insurer or enter into a transaction the effect of which is to reinsure substantially its entire property in order to avoid a conservation order (Code §1011(c)).

The Regulations define the term "substantially its entire property or business" to mean an amount of business such that the sale, cession, assumption or purchase thereof has the potential to render a company insolvent or create a hazard to its policyholders or creditors. A sale, cession, assumption or purchase that equals or exceeds either 75% of an insurer's total premium or 75% of its total liabilities (each of which include direct and assumed business), calculated before the subject transaction, constitutes "substantially its entire property or business" for purposes of §1011(c).

- The Regulations contain detailed provisions concerning regulatory approval of transactions by which a licensed insurer intends to sell, cede, assume or purchase an amount of business that equals or exceeds either 50% of its total premium or 50% of its total liabilities.

Appendix B

California Insurance Code s. 922.2 (a) – credit for reinsurance contractual requirements

922.2.(a) Credit for reinsurance shall be allowed a domestic ceding insurer as either an asset or a deduction from liability in accordance with Sections 922.4 and 922.5 only if the reinsurance contract contains provisions that provide, in substance, as follows:

(1) The reinsurer shall indemnify the ceding insurer for the risk it has assumed according to the terms and conditions contained in the reinsurance contract.

(2) In the event of insolvency and the appointment of a conservator, liquidator, or statutory successor of the ceding company, the reinsurance shall be payable to the conservator liquidator, or statutory successor on the basis of claims allowed against the insolvent company by any court of competent jurisdiction or by any conservator, liquidator, or statutory successor of the company having authority to allow such claims, without diminution because of that insolvency, or because the conservator, liquidator, or statutory successor has failed to pay all or a portion of any claims.

Payments by the reinsurer as set forth in this subdivision shall be made directly to the ceding insurer or to its conservator, liquidator, or statutory successor, except where the contract of insurance or reinsurance specifically provides another payee of such reinsurance in the event of the insolvency of the ceding insurer. The reinsurance contract may provide that the conservator, liquidator, or statutory successor of a ceding insurer shall give written notice of the pendency of a claim against the ceding insurer indicating the policy or bond reinsured, within a reasonable time after such claim is filed and the reinsurer may interpose, at its own expense, in the proceeding where such claim is to be adjudicated, any defense or defenses which it may deem available to the ceding insurer or its conservator, liquidator, or statutory successor.

The expense thus incurred by the reinsurer shall be payable subject to court approval out of the estate of the insolvent ceding insurer as part of the expense of conservation or liquidation to the extent of a proportionate share of the benefit which may accrue to the ceding insurer in conservation or liquidation, solely as a result of the defense undertaken by the reinsurer.