

RAA

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TESTIMONY

OF

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**THE US-EU ECONOMIC RELATIONSHIP:
WHAT COMES NEXT?**

BEFORE

**THE COMMITTEE ON FINANCIAL SERVICES
SUBCOMMITTEE ON DOMESTIC AND
INTERNATIONAL MONETARY POLICY,
TRADE AND TECHNOLOGY**

JUNE 16, 2005

GOOD MORNING CHAIRWOMAN PRYCE, RANKING MEMBER MALONEY
AND MEMBERS OF THE SUBCOMMITTEE.

My name is Frank Nutter and I am President of the Reinsurance Association of America (RAA). Established in 1968, the RAA is a national trade association based in Washington, D.C. We are the leading organization representing the U.S. property and casualty reinsurance industry. Our membership consists of U.S. domestic reinsurers and reinsurance brokers.

Reinsurance is commonly referred to as the insurance of insurance companies. Reinsurance plays a critical role in maintaining the financial health of the insurance marketplace and ensuring the availability of property and casualty insurance for U.S. citizens. Most U.S. insurers concentrate their business on U.S. risks and utilize reinsurance to manage their risk profile and protect against extreme events and volatility in results. In this way insurers diversify their portfolio of risk by "laying off" risks to reinsurers.

Because the U.S. has the most dynamic economy and the greatest risk exposure, it is the leading market for buyers of reinsurance. To that end, reinsurers have financially responded to virtually every major U.S. catastrophe over the past century. The most recent examples would include the insured losses from September 11, 2001, with nearly \$33 billion of insured loss, two thirds of which was reinsured, and the four Florida hurricanes of 2004 with \$27 billion of insured loss, nearly one third of which was reinsured.

Reinsurance is by far the most international of all insurance activities. As the Committee has called this hearing to discuss "The U.S.- E.U. Economic Relationship- What Comes Next?" I am here to share with you the RAA's perspective on the importance of the E.U. reinsurance marketplace to the stability of the U.S. insurance market as well as to discuss some key issues U.S. and E.U. reinsurers face today and in the future.

Global Nature of the Reinsurance Market in the U.S.

To better understand the E.U.'s role in the U.S., it is important to discuss the global nature of the reinsurance marketplace. Despite a large U.S. presence, the global reinsurance market is largely populated by non-U.S. entities. Standard and Poor's reports that of the top 40 reinsurer groups (property casualty and life) only five are U.S.-based companies. Two of the top 10 are U.S.-based. Ten of the top 40, including seven of the top 10, are based in Europe (the E.U. and Switzerland). Bermuda has in recent years become a major corporate home for reinsurers where twelve of the top 40 reinsurance groups are based.

To put the U.S. market in perspective, the global annual net revenue for all reinsurers is approximately \$164 billion. In 2004, U.S. domiciled reinsurers wrote approximately 21% or \$35 billion of that market; yet U.S. insurers purchase nearly \$74 billion of reinsurance from reinsurers not affiliated with the buyer. Currently reinsurance recoverables due U.S. insurers from all reinsurers approximates \$240 billion. As a percentage of U.S. insurers' capital and surplus, this represents 66%.

The RAA's annual study of the financial statements of U.S. property and casualty insurers (2004 data) reflects premiums paid to E.U.-based reinsurers (not including Switzerland) of \$12.7 billion, two thirds of which is paid to reinsurers not affiliated with the buyer. Bermuda-based reinsurers received \$24.3 billion from U.S. insurers, two thirds of which came from buyers affiliated with those non-U.S. insurers. On a global basis, the market for U.S.-based buyers of reinsurance from non-U.S. reinsurers is 46% to Bermuda, 24% to the E.U. and 30% to markets in other locations.

Of the countries where reinsurers are based other than Bermuda, the UK, Germany, Ireland, France and Switzerland are prominent. For the UK, 75% of the U.S.-ceded reinsurance goes to Lloyds of London. Reinsurance broker Guy Carpenter reports that the presence of Lloyds in the U.S. for both insurance and reinsurance revenue has doubled in the last five years.

I cite these detailed financial statistics to highlight that the valued role of the global reinsurance market to support U.S. risks cannot be overstated. Together with U.S. reinsurers (whose property and casualty net premiums written in 2004 is \$30 billion), the non-U.S. reinsurers serve to provide the risk spreading mechanism needed for U.S. insurer companies. With respect to reinsurance written by companies principally in the reinsurance business, non- U.S.-based reinsurers assume U.S. risk for nearly 47% of the U.S. market. This percentage has risen steadily since 1997 when it stood at 38%. If the U.S. subsidiaries of non-U.S.-based reinsurers are added to this total (i.e. the ultimate parent corporation of U.S. companies), the non-U.S. share of the U.S. reinsurance market is 80%.

U.S. Regulatory System for Non U.S. Reinsurers- Importance of Collateral

A relevant consideration for the subject matter of today's hearing is the issue of how U.S. and E.U. reinsurers conduct their business on a global basis. As contrasted with the U.S. market where non-U.S. reinsurers may conduct business through an establishment or through cross border transactions, U.S. insurers and reinsurers primarily conduct business in the E.U. through local subsidiaries rather than on a cross border basis. Standard and Poor's comments "it can be difficult for foreign reinsurers (non-E.U. reinsurers) to obtain material market share because of the strength of existing reinsurer/cedent relationships in Europe." Therefore non-E.U. based reinsurers "acquire existing operations and then manage them so as not to disturb existing relationships."

By contrast, the U.S. regulatory system has fostered a dynamic and open U.S. market by providing options for reinsurers, U.S. and non-U.S., to do business. A reinsurer may, of course, be licensed by the states in the same manner as other insurers. Alternatively, an insurance department may accredit a reinsurer if it submits to the state's jurisdiction examination authority and complies with certain other regulatory requirements. A third option is to be domiciled in a U.S. state that maintains similar regulatory laws as the state granting recognition. In further recognition of the inability of U.S. regulators to assess balance sheets and business activities of foreign entities, a fourth option is available: a reinsurer may establish a trust fund in the amount of its U.S. obligations or provide some other form of security such as a letter of credit. All of these options are available to U.S.-based as well as non-U.S.-based reinsurers.

Some E.U.-based interests have suggested that the fourth option, doing business in the U.S. using trust funds or other collateral, is an impediment to trade. As is clear

from the options in the law and the U.S. market share of non-U.S.-based reinsurance interests (80%), this could not be the case. Security in the form of trust funds, funds withheld by the cedent or letters of credit are options. Many non-U.S. reinsurers obtain licenses in the U.S. (directly or through a subsidiary) and submit to U.S. regulation and accounting policy; while others (47% of the U.S. market and increasing) conduct business on a cross border basis by providing collateral.

Licensing of insurers or the provision of collateral has been a basic tenet of U.S. state regulatory solvency policy: protecting U.S. insurers and policyholders. Licensed U.S. companies, foreign or domestic, must submit to conservative statutory accounting, examination, risk based capital analysis, and actuarial certification. As an alternative, companies that choose to be based in non-U.S. jurisdictions for business, regulatory or tax considerations, may, under U.S. laws, conduct reinsurance by providing collateral. Like their regulatory counterparts, U.S. insurers have uniformly endorsed these optional approaches (licensing or collateral) as a means to have access to global markets and yet protect their solvency and their policyholders against the credit risk imposed by the reliance on non-U.S. based reinsurance recoverables.

NAIC Consideration of U.S. Collateral Requirements

At the insistence of some E.U.-based interests, the National Association of Insurance Commissioners (NAIC) has undertaken an examination of alternatives to the current optional regulatory system. The NAIC Reinsurance Task Force in March 2004 resolved to evaluate any alternatives in relation to:

- The existence and implementation in key countries of comprehensive regulation of reinsurers, including risk based capital;
- whether U.S. judgments in favor of U.S. cedents and receivers are consistently enforced; and
- the adoption and implementation of international insurance accounting standards that are consistent with recognized statutory accounting principles.

At its June 2005 meeting, the NAIC Reinsurance Task Force acknowledged that a series of meetings have taken place in an effort to develop alternatives. The Task Force expects to evaluate these alternatives beginning this Fall. Throughout the process, U.S. insurer interests have, however, consistently argued that:

- the current optional system, particularly the collateral alternative, provides the necessary balance between their ability to obtain needed capacity while maintaining basic consumer protection and appropriate regulation for solvency;
- any reduction in collateral would expose them to dramatically increased credit risk (per the above \$240 billion of reinsurance due U.S. insurers from U.S. and non- U.S.-based insurers--- \$75 billion is secured by collateral or trust funds (plus about \$10 billion in Lloyd's trusts));
- the regulatory system has fostered a competitive international market for buyers of reinsurance and that the cost, if any, associated with collateral is an acceptable cost of doing business for the security associated with it;

- the cost of alternatives to collateral would be borne solely by U.S. buyers even though it would only benefit non-U.S. reinsurers;
- collateral is not viewed as a trade barrier but a facilitator of accessing non- US reinsurance capacity and market access for non US reinsurers.

In March 2003 the U.S. Trade Representative (USTR) acknowledged the interest of a WTO member state in the collateral "issue." It further recognized the prudential nature of the issue pursuant to state regulatory solvency considerations and chose not to include it among issues to be addressed in the current trade talks. The USTR acknowledged that the National Association of Insurance Commissioners in 1993 adopted a model law (now in effect in all states) that allows non-U.S. insurance providers entry in the US without their prior establishment in any state.

E.U. Reinsurance Directive, Considerations for U.S. Market

The E.U. Parliament has recently adopted a Reinsurance Directive permitting E.U. licensed companies in all Member States to conduct reinsurance across borders without an establishment in the other E.U. country. (The E.U. Council is scheduled to address the directive in October.) We commend the E.U. for making uniform the regulatory basis to do business in all E.U. countries. While the directive defers some fundamental regulatory practices common in the U.S. to the Solvency II initiative, once adopted by Member States, it achieves something not found in the U.S.- uniformity and mutual recognition of regulatory practice among states.

The U.S. insurance industry recognizes that some form of mutual recognition between the U.S. and the E.U. and other foreign states might in time be appropriate.

However, U.S. insurance trade groups have stated that the following prerequisites must occur before mutual recognition is appropriate:

- the non-U.S. reinsurer must report its financials on a U.S. GAAP basis with certain statutory adjustments;
- the non- U.S. jurisdiction must meet a high standard of insurance regulation (regulatory equivalence);
- the non- U.S. entity must submit to U.S. jurisdiction;
- U.S. (re)insurers must be subject to no greater regulation in the U.S. than the non- U.S. reinsurer is subject to in its home jurisdiction; and
- U.S. judgments must be subject to recognition and enforcement in the foreign jurisdiction.

Conclusion

E.U. and other non-U.S. based reinsurers provide great value to the U.S. insurance market as a risk transfer mechanism. Fortunately the U.S. regulatory system provides options to access that market and yet provides U.S. consumers with the security and solvency protection appropriate to their needs. The RAA appreciates the Committee's interest in the relationship between the U.S. and E.U. reinsurance industries and we look forward to working with the Committee in the future on such issues.