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The Impact of Recent Events on the Insurance Industry

by NAIC Staff

Clearly the disastrous series of events that took place on September 11, 2001, shook America's foundation. There is, however, a silver lining in that cloud of doom and despair. The insurance industry provides a unique set of products that are meant to help people and businesses restore order from chaos. In this time of need, it is the insurance industry that will be called upon to deliver on the promises that it has made. Insurance is the salve that will help heal America's wounds. While life insurance cannot replace a loved one, it can add economic stability to the families of the deceased. Various property and casualty insurance products are designed to help families and businesses rebuild what is lost.

The insurance industry is in the business of accepting transfers of risk. It is this important function that provides the owners of America's businesses with the ability to sleep at night. They rest assured because the potentially devastating financial consequences of natural and human events have been assumed by companies that specialize in accepting and managing risk. The recent tragic events in New York and Washington, DC have led Americans to call upon insurers to make good on the promises that were made. There are several wonderful stories to tell about how insurers stepped forward and provided needed relief to American businesses and families. Following these tragic events and the comfort that insurers provided the nation, insurers' perception of the risks they are willing to assume has drastically changed. This article will try to outline some of the events that have occurred and the reaction of the markets and insurance regulators to them.

Financial Impact on Companies

Immediately following September 11, the NAIC, through its Financial Analysis Working Group, began to take a look at the impact these events would have on insurers' financial position. Insurance regulators focused particularly on those companies that were heavy writers of business in New York, New Jersey, and Connecticut. Insurance regulators identified about 20 primary insurance groups representing 150 property and casualty companies, about 20 reinsurance groups, about 50 U.S. and international reinsurance companies—including several Lloyd's of London syndicates—and looked closely at their financial wherewithal. Together, these groups accounted for more than 90 percent of the estimated losses from these tragic events.

Insurance regulators prepared and implemented financial impact surveys during the fourth quarter and asked a number of questions about the losses, reinsurance arrangements, liquidity issues, and so forth. They found that the losses were large, but manageable. No specific solvency concerns were identified; however, insurance regulators continue to actively monitor the situation. The working group has also been looking at the investments very carefully—including the performance of scenario testing—and looking at the industry's asset exposure, particularly in the sectors that are directly affected by the events of September 11. The scenario testing considered market risks in the airline and transportation sectors, travel and insurance sectors, trust bond markets, and stock markets in general. The life insurance industry is going to assume much of the market risk of the insurance sector. While the regulators found some insurers have particularly heavy exposures in these holdings, overall the industry appears to be well diversified. There were less than 100 of more than 4,800 companies that were included in the analysis that had very significant capital surplus decreases under these scenarios.

Terrorism Exclusions

Following September 11, it became clear that there was a significant risk that had not previously been contemplated by insurers in most situations. It was also clear that it is a risk that was difficult for the insurance industry to manage and price. It is a risk that has potentially catastrophic severity and is of indeterminate frequency.

Soon after the tragic events, shortly after insurance industry leaders had come forward and declared that exclusions for acts of war would not be invoked, the reinsurance industry

Continued on page 2

The Impact of Recent Events on the Insurance Industry

Continued from page 1

began to signal that it would be excluding terrorism in future reinsurance contracts. The most common effective date for reinsurance contracts renewals is January 1. It is estimated that 70 percent of all reinsurance contracts have a January 1 effective date. Fearful that these exclusions would leave primary insurers exposed to significant losses that they were not ready to bear, the NAIC and a number of other groups have been working for the past several months to try to get federal legislation enacted that would limit the insurance industry's losses in the future. While they were actively seeking a federal solution to address the void in reinsurance coverage for acts of terrorism, insurance regulators and representatives of the insurance industry also recognized that federal legislation might not be enacted.

The insurance industry began filing exclusions for acts of terrorism with the states in October and November of 2001. At that point, the insurance regulators in most states held the filings in abeyance for several reasons, including:

- First, most insurance regulators continued to hope, up until the time Congress adjourned, that there would be a federal solution and that it would have a significant effect on how one might deal with the terrorism exclusions being filed.
- Second, there was real discomfort with the broad language that was contained in the exclusions. Many exclusions that were being filed were very broad, and in some cases were ambiguous. They would have excluded things that had historically been covered—more limited types of losses such as a bombing of an abortion clinic—and insurance regulators wanted to find a way to be able to continue to have coverage for those limited areas.
- Third, insurance regulators received a lot of feedback from the insurance industry that it was important that there be a national solution. It was also clear that among insurance regulators, agreement on a solution would take some time and effort to obtain.

Insurance regulators were between a rock and a hard place. If a regulator were to approve the exclusions, the risk and the problems associated with it are simply passed on to the insured, who has no coverage for acts of terrorism and who may not have the means to address it. On the other hand, if a regulator were to disapprove the exclusions and force the primary insurance industry to continue to provide coverage for acts of terrorism, one risks the solvency of an insurer and, in the event of an insolvency, the resulting losses would fall to other policyholders through the guaranty fund system. Neither outcome was ideal.

Furthermore, insurance regulators began to hear stories of market disruption, non-renewals, and business moving offshore to escape policy form regulation. This demonstrates that just because an insurance regulator tells an insurer that it cannot exclude coverage for acts of terrorism does not mean that coverage for acts of terrorism will necessarily be written. As a result, insurance regulators concluded that they needed to take a hard look at the exclusions to see if they could be narrowed to avoid some of the problems.

The NAIC has been engaged in a two-track process for the last couple of months. First, the NAIC has been working with Congress to help them understand the need for a federal backstop for acts of terrorism. NAIC members and staff have been involved with designing a temporary federal solution and providing input and information that is used by Congress in designing prospective bills. Second, the NAIC membership has been engaged in a dialog regarding possible exclusionary language, trying to come up with a solution if Congress failed to act. Eventually, on December 21, 2001, the NAIC concluded that if Congress adjourned without enacting a federal backstop, the states should approve narrow exclusions for acts of terrorism for commercial lines insurance policies. Specifically, the recommendation was that this exclusion would apply if the aggregate insured losses exceeded $25 million for interrelated events within a 72-hour period. While that is a modest number, it was intended to capture the kind of limited areas mentioned earlier. Certainly, that number pales in comparison to losses of September 11. In addition, coverage for nuclear events caused by acts of terrorism is excluded from the first dollar. Overt acts of biological or chemical terrorism are excluded from the first dollar. Overt acts are acts that actually involve or are carried out by the means of the disbursement of biological agents or chemicals or attacking a property with intentional release of biological or chemical agents as opposed to an incidental release of hazardous materials resulting from an act of terrorism. Also in the case of liability insurance coverage, the exclusion would apply if 50 or more individuals were killed or severely injured during the event.

The NAIC also recommended that the approval be “conditional.” That is, it would be subject to withdrawal 15 working days after the President signs legislation, if permitted by state law. Thus, if the President were to sign into law a federal backstop for acts of terrorism, 15 working days later, insurers would no longer be permitted to use these exclusions. The 15-day period would provide insurance regulators with an opportunity to assess the legislation and reconsider what action might be appropriate in terms of exclusions, if any.

Shortly after the NAIC finished its recommendation, Congress adjourned without acting, and the NAIC immediately kicked into high gear. A model bulletin was drafted that included an expedited approval process. Insurance Services Office, Inc. (ISO) re-filed exclusions according to the language agreed to by the NAIC membership. By the end of the first week in January, there were 35 jurisdictions that had approved the ISO filing. As of Jan. 17, 47 jurisdictions had approved this ISO filing. It was still under consideration in California, Georgia, Florida, New York, and Texas.

There are two complications that remain in the commercial area. The exclusion does not eliminate all of the terrorism exposure that insurers have for commercial lines. The first problem is workers compensation. State laws do not permit exclusions of coverage for acts of terrorism for workers compensation. Under a workers compensation policy, the insurer simply agrees to pay what the state law requires it to pay on behalf of an employer. The policies that are written by the insurance industry simply refer back to the state statutes under a simple insuring agreement and pay the benefits that are required by statutes. State laws have no provision for an insurer to assume part, but not all, of this exposure. Thus, insurers continue to have a significant exposure to catastrophic loss for acts of terrorism in the workers compensation line. In addition, in 29 states, there is a standard fire policy that is based on the old New York 165-line fire policy that was codified many years ago in the states’ statutes. The implication of the codification of the fire policy is that policies must continue to cover any ensuing fire that follows a terrorist act. So, while an insurer can exclude the terrorist act itself, it must hope there is no ensuing fire. In the case of the World Trade Center events, fire following claims represented a significant part of the loss. ISO has developed a separate endorsement for states where the standard fire policy is included in the law.

In addition, insurance regulators have recently received filings asking to exclude coverage for acts of terrorism in personal lines and for group life insurance. The NAIC adopted a motion that effectively precluded the use of exclusions for personal lines. The motion follows:

> It is the sense of the NAIC membership that terrorism exclusions are generally not necessary in personal lines property and casualty products to maintain a competitive market, and they may violate state law. However, we recognize that state laws vary in their authority and discretion. Further, there may be unique company circumstances that need to be considered in individual cases. We expect these cases to be limited.

At the time this was written, the NAIC is still reviewing the group life insurance exclusions.

Insurance Market in General

The Reinsurance Task Force of the NAIC held a public hearing in Washington, DC on January 17, 2002. Insurance regulators had been hearing widespread anecdotal reports of significant rate increases and availability issues, not just related to acts of terrorism, but across the board. The hearing included representatives from the primary insurance companies—both property and casualty and life-reinsurers, insurance brokers and reinsurance intermediaries, and some financial analysts to hear what they had to say about what is occurring in the market.

Insurance regulators were aware that prior to September 11 there were some adjustments in pricing taking place. The insurance industry has experienced underwriting losses for many lines of business in recent years, and it was clear that there needed to be some price adjustment. Insurance regulators were receiving rate filings in the range of 10 to 20 percent even before September 11. That phenomenon appears to have accelerated since September 11, particularly in November and December of

Continued on page 4

The Impact of Recent Events on the Insurance Industry

Continued from page 3

2001. While acts of terrorism play a role, it is likely that significant rate changes would have taken place regardless of the tragic events. It is the confluence of three factors that seem to be driving insurance prices. First, the soft market is over and rates will rise as insurers tighten their underwriting and pricing standards. Second, investment income results last year were abysmal and cannot be relied upon to support dismal underwriting results. Finally reinsurance costs have risen, sometimes substantially, and reinsurance coverage restrictions have been introduced.

What insurance regulators heard during the hearing on January 17, 2002, was that different markets are being affected differently. In the small commercial market and the homeowners market, coverage for acts of terrorism is still available, it appears, unless there is a serious terrorism exposure for a specific risk. Further, rate increases tend to be in the 10 to 30 percent range. In the middle market, there are larger increases in some pockets. There are some issues for lines of business or classes of business that have been problem areas that had significant losses. Exclusions for acts of terrorism are more common in the middle market but by no means universal. In the large market—the Fortune 1000 companies—the brokers are running into capacity problems. Those capacity problems are driving even larger increases and the exclusions for acts of terrorism in that market are essentially universal. A separate terrorism insurance market has developed where companies can get some amount of coverage up to, say, $300 million, but at some fairly substantial rates.

Reinsurance rates are going up significantly, particularly in property and workers compensation insurance. Insurers are much more concerned about the concentration of risk that exists in workers compensation. Insurers are looking at how many employees are at one site, again particularly in light of the fact that they cannot exclude terrorism in workers compensation. This concentration issue has become a significant concern in the underwriting process. It is very difficult to separate the impact of events of September 11 and the terrorism issue from the other underlying market issues that are driving market change.

As mentioned earlier in the article, there is some evidence that a price adjustment was needed prior to September 11. Since September 11, the market has experienced some reduction in available capital, although there have been several significant capital commitments, particularly in the reinsurance industry. Primary insurers now have limited exclusions available to them for acts of terrorism. This is not an ideal solution as America's businesses are exposed to significant losses for acts of terrorism for which they cannot obtain insurance protection. Also, small or weakly capitalized insurers are at risk as although there is a requirement that an event exceed $25 million in aggregate loss, if the event occurs primarily to their policyholder, survival of the entity could be a major concern. Thus, what we have is more accurately described as a Band-Aid® than a viable solution. It is not perfect and there remains significant cause for concern.

What was relayed to insurance regulators at the reinsurance hearing in mid-January is that a "cloud" of terrorism hovers over the insurance industry. It has really caused insurers to be much more careful in how they underwrite and accept risk. So, in the underwriting process, insurers are being very careful and the result is appearing sometimes in rate increases and sometimes in coverage availability. It appears that the terrorism problem and the events of September 11 are exacerbating some underlying market dynamics that would have existed in any event. The good news is that capital is coming into the industry in a rapid pace, particularly into the reinsurance sector. This should help ease the capacity problem and some of the market disruptions that are occurring.

These changing market conditions should be viewed as an evolution rather than a revolution. Not all insurance contracts changed on January 1, 2002. While many reinsurance policies have a common January 1 effective date, most primary insurance policies do not. American businesses will be experiencing a newfound lack of coverage for acts of terrorism throughout the year as their policies renew. This may be invisible to them unless there is a major terrorist event that causes insured losses that exceed $25 million. If that threshold is not pierced, it will seem as if things were proceeding as if it were business as usual. Only following another major event can we assess how well the economy performs when insurers are not there to fill a void that exists. A major event may cause an economic disruption, as perhaps some businesses will have coverage while others will not. Those that are not covered for the event face the daunting challenge of trying to figure out how their business will survive. Perhaps Congress will see fit to provide grants or low-interest loans to the businesses that are affected. Only time will tell.

Prospects for Federal Legislation

What was driving Congress in the fall as they were considering enacting backstop legislation was not really a concern about the solvency of the insurance industry or the affect of the terrorism issue on the insurance industry. What was driving Congress was the concern about the broader economic effects that a lack of terrorism coverage might cause. Representatives of insurers and reinsurers were telling the Administration and Congress that if they did not have a federal backstop for acts of terrorism, that primary insurers would not provide the coverage. They predicted that businesses would not be able to get loans, existing loans would be called, businesses would be in default on loan agreements, and businesses would have difficulty raising new capital to expand their business or build new buildings. There were predictions of significant economic upheaval if no coverage for acts of terrorism existed.

Many people were surprised when January 1 came and went and there was no significant economic fallout. Financial institutions did not stop loaning money and the economy did not grind to a halt. Congress is seeking information about the impact on America's businesses. Congress wants to find concrete examples to show businesses are unable to obtain loans or make capital improvements or where lenders call outstanding mortgages because the insurers have decided to include exclusions for acts of terrorism in insurance contracts.

Certainly these issues concerning market disruption—particularly significant price increases—are a concern. Insurance regulators will need to look carefully into these market dislocations and determine what, if anything, needs to be done to address them. Rates are regulated in many, but not all, states and insurance regulators need to provide information that will help Congress figure out what to do. Congress is really struggling at this point to get some concrete examples of more widespread economic impact. It was fairly clear during the reinsurance hearing on January 17th that unless the insurance industry can come up with some evidence that this more widespread economic impact is occurring, it is going to be very difficult to convince Congress that this is a problem that needs addressing. The NAIC membership continues to think that a federal terrorism solution would help to address this uncertainty that hangs over the industry that stems from the terrorism issue.

The House Financial Services Committee was initially planning to hold a hearing to examine the present need for federal terrorism insurance legislation as early as January 23, when Congress reconvened. However, it appears that no hearing will be held until or unless the GAO reports back with firm evidence of problems. On the Senate side, the staff director of the Banking Committee said that major problems would need to become evident before his committee would revisit terrorism insurance legislation in 2002. The NAIC has initiated a survey of its members that will attempt to collect information from rate filings to help Congress assess and evaluate the need to enact a federal backstop for acts of terrorism. The survey also polls consumer assistance personnel in an effort to identify complaints from businesses and families related to the availability and affordability of insurance coverage. Unless this survey provides the necessary information to convince Congress that the potential for economic disruption is significant, it would appear that the outlook for enacting a federal backstop is dim. Or, God forbid, another significant act of terrorism should do the trick. ■

Rating Organization Response to Terrorism Issues

by Peter M. Burton, CPCU, AU

In the wake of the September 11, 2001, terrorist attacks that resulted in a significant number of workers compensation claims, the National Council on Compensation Insurance (NCCI) had to rethink how rating systems should respond to man-made catastrophes. In late December, we filed with regulators two countrywide item filings: E-1376—Exclusion of Terrorism Losses from Experience Rating, and B-1377—Catastrophe Provision.

Item E-1376

Item E-1376 proposes that claims directly attributable to the terrorist attacks that are reported under Catastrophe Number 48 be excluded from experience calculations. This filing is proposed to be effective for all experience modifications with rating effective dates of May 27, 2002, through June 14, 2006.

It is the basic tenet of the Experience Rating Plan that the modification factor be predictive of an employer's future loss experience. Items that are within the employer's control, such as workplace safety, loss prevention, and loss control programs, play a key role in deriving the experience modification. Events that are completely beyond the control of the employer, such as intentional plane crashes, are not good predictors of an employer's future loss experience. The unique and unprecedented nature of the claims directly attributed to the terrorist attacks of September 11 are felt to be beyond the control of employers, and for these unique acts, it is felt that individual employer experience modifications should not be negatively affected. This filing currently is receiving favorable regulatory reaction.

Item B-1377

In addition to experience modification changes, NCCI also filed Item B-1377—Catastrophe Provision. This filing proposes a catastrophe loading of 4 percent be applied to all loss costs/rates for all class codes. This filing is proposed to be effective January 1, 2002, for new, renewal, and in-force policies.

Given the build-up of terrorist events in recent years, coupled with the significant number of highly populated areas, density of employees in high-rise locations, and landmarks, nuclear power plants, and military bases as potential targets, a catastrophe provision was considered the fairest, most equitable means of securing sufficient funds to cover future catastrophic losses. While this filing specifically focuses on terrorism, we continue to evaluate catastrophes in general and plan to engage in further modeling to measure other catastrophic exposures.

This filing is currently being reviewed by individual state regulators and the NAIC's Workers Compensation (C) Task Force. We are committed to working with the NAIC, individual regulators, and the insurance community to explain and refine our proposal, if necessary, to ensure that increased catastrophe exposures are properly funded to cover future losses. ■

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Symposium on Debt Cancellation Contracts and Credit Insurance of the Functional Regulation Working Group of the Financial Services Modernization (G) Task Force Summary

During the NAIC's 2001 Winter National Meeting, the NAIC's Functional Regulation (G) Working Group and the Regulatory & Legislative Section of the CPCU Society co-hosted a symposium on debt cancellation contracts (DCCs) and credit insurance. More than 150 individuals interested in the regulatory and consumer protection issues that surround these competing financial services products attended the symposium. Director Nat Shapo (IL) served as symposium moderator. He observed that the competition between DCCs and credit insurance products is the first test of the concept of functional regulation that was introduced in the Gramm-Leach-Bliley Act (GLBA).

Director L. Tim Wagner (NE) provided an interesting historical perspective on the development of credit insurance and the later introduction of DCCs. He provided a regulatory perspective related to consumer protection issues. He believes that the demise of credit insurance products for credit cards is imminent. Linda Kaiser (Saul-Ewing), a former insurance commissioner in Pennsylvania, provided an overview of how the GLBA affects these products and competition among the depository institutions and credit insurers.

Commissioner José Montemayor (TX) discussed the position of the Texas Department of Insurance that DCCs are insurance products and should be regulated as such.

Jim McIntyre (McIntyre Law Firm) presented information on DCCs from a banking perspective. He maintained that DCCs are banking products because they are simply additional terms that apply to a loan. He cited various federal determinations that declare DCCs to be banking products. He maintained that DCCs involve no transfer of funds or risk pooling mechanisms. He observed that DCCs are not subject to reverse competition as there are no intermediaries demanding a commission payment.

Gary Fagg is an actuary and noted author on credit insurance matters. He, too, predicts that the $6 billion credit insurance industry will, by 2005, be reduced to less $2 billion as a result of migration from credit insurance to DCCs. He believes that a regulatory scheme for credit insurance should be balanced and provide adequate disclosure. He is a strong proponent of component rating along with a variable loss ratio standard for each product. He believes that debt protection will grow into a $10 billion industry.

David "Birny" Birnbaum (Center for Economic Justice) presented a consumer perspective regarding both credit insurance and DCCs. He described the DCCs, credit life, and disability products in a hierarchy. He believes that some of the banking products such as debt suspension agreements are less beneficial to consumers. He observed that credit card credit insurance is rapidly disappearing. He added that retail cards also offer DCCs. He hoped that DCCs would replace credit insurance in ways that are beneficial to consumers. They may bring greater uniformity and consistency. There may also bring expanded consumer choice and potentially richer benefits. He suggested four items that must occur to DCCs to protect consumers:

- They need to provide for a minimum level of benefits.
- They need a minimum ratio of benefits to fees charged that is of value to consumers.
- There needs to be consumer choice and adequate disclosure.
- There should be no replay of problems with single premium credit insurance.

Director Shapo closed the meeting by thanking all of the participants for their thoughtful and informative comments. ■

Worldwide Reinsurers all Financially Impacted by World Trade Center Tragedy

by Andrew J. Barile, CPCU

Introduction

The largest ever catastrophe to the insurance industry will result in insured losses approaching $60 billion dollars. The extent of the financial loss will involve property damage, business interruption, workers compensation, aviation, automobile, and life insurance losses. The purpose of this article is to bring some focus on the accuracy of the financial assessment of the catastrophe. It is important that the distribution of risk within the insurance industry be understood and the methodology be further understood from insurer to reinsurer to retrocessionaire.

Business of Reinsurance

The business of reinsurance is a comparatively small but integral part of the overall insurance industry. For instance, where as there are some 3,000 property and casualty insurance companies operating in the United States that buy reinsurance, there are only some 30 U.S. reinsurers who *sell* reinsurance.

To make matters more complicated today, reinsurers in the past 10 years have become vertically integrated, meaning that reinsurers today also finance primary insurers, whether they be *admitted* or *non-admitted* carriers.

Reinsurance/ Retrocession Defined

Simply defined, reinsurance is transacted on the basis of an insurance company, the "*reinsurer*," agreeing to indemnify another insurance company, the "*reinsured*," for all or part of the insurance risks underwritten by the reinsured (i.e., insurance company). In turn, the reinsurers of the insurance company, to spread their risk, have purchased reinsurance, which is defined as a retrocession (meaning the purchase by a reinsurer of reinsurance). The reinsurance programs of the reinsurance companies have made the reinsurance business a truly global business. South America reinsurance companies will pay a part of the loss in the World Trade Center disaster.

Reinsurance—A Non-Regulated Industry

The reinsurance transaction takes place entirely between insurance companies (we used to say insurance professionals), with comparatively very little state regulatory control on reinsurance agreement language (referred to as Treaty Reinsurance Agreements and Facultative Reinsurance Certificates) and reinsurance pricing. The insurance-buying public is not aware of its existence, or its very importance in times of catastrophic events.

Defining the Insurance Industry Risk Assumption Distribution System

To better understand the insurance industry risk assumption system, let's look at the recent catastrophic loss at New York's World Trade Center, where initial estimates of insured loss could reach $60 billion, and property damage alone could reach $10 billion. In 1993, insurers and their reinsurers only paid $500 million for the World Trade Center bombing, and only $12.5 billion of insured/reinsured losses for the Northridge, California earthquake.

Facultataive Reinsurance versus Treaty Reinsurance

The corporate insurance buyers in the World Trade Center disaster responsible for purchasing many millions of dollars of insurance coverage will, by necessity, become exposed to the intracies of the types of reinsurance facultative reinsurance and treaty reinsurance.

Facultative Reinsurance

Facultative reinsurance is the reinsurance of one specific risk, or one individual risk regardless of the amount of the limit of insurance. Initial reports indicate that The Port Authority of New York is the named insured on the property policies covering the entire World Trade Center complex with total limits of $3.2 billion. The business interruption insurance program had limits of $1.5 billion. For reinsurance purposes, this would be considered one risk.

If a primary insurance company wrote the first $100 million of property coverage on this risk, and then ceded out shares of that risk to reinsurers, those reinsurers would be considered facultative reinsurers (also referred to as property facultative reinsurers).

Expressed another way, the primary insurers providing direct insurance coverage for special insured (i.e., World Trade Center) would gross up their insurance capacity to a single limit or amount of coverage, which is what the policyholder actually sees, but behind that gross limit is reinsurance capacity that can be on a facultative reinsurance basis. Permitting primary insurance companies to gross up their insurance capacity, on an individual risk, is a major contribution of the worldwide facultative reinsurance market.

Let's continue with our illustration; if the primary insurer wrote a $100 million property policy, it is not inconceivable for that insurer to cede out $90 million in excess of $10 million to individual facultative reinsurers, on an excess of loss basis.

Forms of Reinsurance Methods—Pro Rata and Excess of Loss

The pro rata, or form, of reinsurance shows a sharing relationship. On the $100 million primary policy, 90 percent of the risk, or $90 million, could have been ceded to the facultative reinsurers, for 90 percent of the premium charged for the $100 million primary policy. Common terminology would show that this facultative property reinsurance certificate was written on a pro-rata basis.

The excess of loss form of reinsurance, a more likely methodology, as respects the World Trade Center risk, would have the primary insurer purchasing on the $100 million policy, $90 million in excess of $10 million, at a pre-agreed reinsurance price (i.e., so many dollars per million of reinsurance limit). If the loss to the primary policy were in excess of $10 million, which it is, the facultative reinsurer would pay the dollar loss over the $10 million primary retention.

To summarize, the primary insurer to provide $100 million of insurance capacity on the World Trade Center could have purchased the reinsurance on either a pro-rata basis or an excess of loss basis. The reinsurance negotiating process takes over here to determine which is more advantageous to the primary insurer. Unregulated reinsurance pricing on an excess of loss basis will be discussed in future articles.

Defining Treaty Reinsurance

The other type of reinsurance provided to primary insurers is treaty reinsurance, whereby entire portfolios of individual policies are automatically covered by treaty reinsurance agreements. Once again, the reinsurer provides the capacity, but on the basis that the reinsurance is structured automatically, for many insureds. All of the primary insurer's property insurance policies are covered under the Treaty Reinsurance Agreement. The Treaty Reinsurance Agreement automatically covers individual risks.

This is why initial estimates of loss reported by reinsurers may take longer to predict. Supposing, and this is only an example, the property treaty reinsurer for the primary property insurer wrote the treaty reinsurance agreements on several insurance companies, all of which wrote the primary insurance policies on the World Trade Center. Then that treaty reinsurer would be exposed to a multiple of losses from many property treaties.

Retrocession Protection for Reinsurers

In order to protect a reinsurer's net worth, the reinsurer purchases reinsurance, usually on an excess of loss basis. That type of reinsurance protection purchased by a reinsurance company is called retrocession. The reinsurance of reinsurance companies operates completely in a freely regulated environment. The Lloyd's Syndicate that underwrites the retrocession of a European reinsurer is free to negotiate both a reinsurance price, and a reinsurance agreement, in an unregulated environment and across different continents. This is referred to as the worldwide reinsurance market, and its risk-taking appetite is always a direct function of the available capital in the reinsurance marketplace. Most of us practitioners now realize that a substantial amount of that worldwide reinsurer's capital is going to go into paying the World Trade Center losses.

Continued on page 10

Continued from page 9

Understanding the Insurance Collection System in Times of Catastrophic Events

The system of collection of insurance proceeds can be easily described as insurers paying claims to policyholders, and collecting reinsurance receivables from reinsurers. Reinsurers, in turn, collect their claims from the retrocessionaires. To complicate the system in earlier catastrophic events, primary insurers also come back at risk to pay additional claims because they underwrote the retrocessions of their reinsurers.

Issues in Collecting Reinsurance Receivables

The collection of reinsurance receivables because of the magnitude of the primary insured loss will also become a significant complex task. Insurers using their reinsurance intermediaries will focus on collecting reinsurance recoveries. Each primary insurer has to collect from its reinsurer, and the reinsurers have to collect from their retrocessionaires.

Use of Finite Risk Reinsurance Treaty Reinsurance Clauses in Retrocession Agreements

As was explicitly pointed out in my book, *A Practical Guide to Finite Risk Insurance and Reinsurance*, the major characteristic of finite risk reinsurance is to *cap* or *maximize* the amount of reinsurance loss in the agreement. Retrocessionaires who were able to provide reinsurance of the reinsurers utilizing Finite Risk Reinsurance agreements may have instituted new clauses in their retrocession agreements that give them the ability to put a limit on the amount of the reinsurance recovery, as respects a catastrophic event. These new clauses may cause reinsurance disputes between reinsurers and their retrocessionaires, and slow down the reinsurance recovery process.

Conclusion

How many insurers and their reinsurers will participate in this catastrophic event? One more time, the insurance and reinsurance industry will be tested, and always in a time of property devastation and loss of life, of catastrophic proportions. In my 40 years in the insurance and reinsurance business, I would never have imagined the collapse of both towers of the World Trade Center and the loss of four major airliners. ■

Effects of the Anti-Money Laundering Provisions[1] of the USA Patriot Act on Insurance Companies and Insurance Regulators

by Robert Ober, NAIC Antifraud Coordinator

Background

Money laundering can briefly be described as the process by which the cash proceeds of criminal activity are made to appear legitimate. The federal government has enacted laws designed to make the money-laundering process more difficult. Such laws criminalize the act of money laundering (Money Laundering Control Act) and establish reporting requirements for certain types of currency transactions and suspicious activity (Bank Secrecy Act). The reporting requirements are primarily directed at banks; historically, insurance companies have not been subject to federal anti-money laundering reporting requirements.

The Money Laundering Control Act of 1986

The Money Laundering Control Act is codified at 18 USC 1956, 1957, and, under certain circumstances, makes it a federal felony to spend, save, transport, or transmit proceeds of criminal activity.

The Bank Secrecy Act of 1970

The Bank Secrecy Act[2] (BSA) is codified at 31 USC 5311-5330 and gives the Secretary of the U.S. Treasury Department broad powers to implement anti-money laundering regulations on financial institutions, and such regulations are implemented by the Treasury Secretary through 31 CFR 103. The BSA requires banks and other financial institutions to file "currency transaction reports" and "suspicious activity reports" with the Treasury Department upon performing certain transactions. "Financial institutions" are defined at 31 USC 5312, which does explicitly include "insurance companies." However, even though the BSA gives the Treasury Secretary the authority to impose BSA anti-money laundering requirements on insurance companies, the Secretary has yet to choose to do so.

The USA Patriot Act of 2001

The USA Patriot Act was enacted by President Bush on Oct. 26, 2001, and is directed primarily at anti-terrorism. Title III of the act contains several new anti-money laundering provisions that affect financial institutions and may affect insurance companies and insurance regulators. The Treasury Secretary has the authority to impose these provisions on financial institutions, and since the definition of financial institutions includes insurance companies, these provisions may also be imposed on insurance companies unless exempted through regulation. The applicable sections are as follows:

Sec. 311. Special Measures for Jurisdictions, Financial Institutions, or International Transactions of Primary Money Laundering Concern.

(to be codified at 31 USC 5318A)

The Secretary *may* require domestic financial institutions and domestic financial agencies to maintain records and/or file reports on certain transactions if such transactions are determined by the Secretary to be of primary money laundering concern. In determining which transactions are of concern, the Secretary will consider the international, jurisdictional, and institutional factors of the transaction. The reports shall include:

1. The identity and address of participants in the transaction, including the identity of the originator of any funds transfer.

2. The legal capacity in which a participant in the transaction is acting.

3. The identity of the beneficial owner of funds involved in the transaction.

4. A description of the transaction.

With respect to non-bank financial institutions, the Secretary shall define the term "account" after consultation with the *federal* functional regulators (as defined in sec. 509 of the Gramm-Leach-Bliley Act).

Sec. 314. Cooperative Efforts to Deter Money Laundering.

By February 23, 2002, the Secretary *shall* adopt regulations to encourage cooperation among financial institutions, their regulatory authorities, and law enforcement, with the specific purpose of encouraging regulatory authorities and law enforcement to share money-laundering information on individuals, entities, and organizations with financial institutions. Also, upon notice to the Secretary, two or more financial institutions and any *association* of financial institutions may share information with one another regarding the money laundering activities of individuals, entities, organizations, and countries. Such sharing shall not be liable for prosecution under any law and shall not constitute a violation of Title V privacy protections of the Gramm-Leach-Bliley Act.

Continued on page 12

Effects of the Anti-Money Laundering Provisions of the USA Patriot Act on Insurance Companies and Insurance Regulators

Continued from page 11

At least semi-annually, the Secretary shall distribute a detailed analysis of suspicious activity to financial institutions.

Sec. 326. Verification of Identification.

(to be codified at 31 USC 5318(l))

The Secretary *shall* prescribe regulations to require financial institutions (including insurance companies unless exempted) to implement reasonable procedures to:

1. Verify the identity of any person seeking to open an account to the extent reasonable and practicable.
2. Maintain records of the information used to verify a person's identity, including name, address, and other information.
3. Consult lists of known or suspected terrorists or terrorist organizations provided to the financial institution by any government agency to determine whether a person seeking to open an account appears on any such list. Such regulations shall take effect by October 25, 2002.

Such regulations shall be prescribed jointly with each *federal* functional regulator (as defined in sec. 509 of the GLBA). The Secretary may exempt any financial institution or type of account from the regulations.

Sec. 352. Anti-Money Laundering Programs.

(to be codified at 31 USC 5318(h))

By April 24, 2002, each financial institution (including insurance companies unless exempted) *shall* establish anti-money laundering programs that include, at a minimum:

1. The development of internal policies, procedures, and controls.
2. The designation of a compliance officer.
3. An ongoing employee training program.
4. An independent audit function to test the anti-money laundering programs.

After consultation with the *federal* functional regulators (as defined in sec. 509 of the GLBA), the Secretary *may* prescribe minimum standards for anti-money laundering programs, and *may* exempt insurance companies. ■

Endnotes:

1. Detailed in "The International Money Laundering Abatement and Anti-Terrorist Financing Act of 2001," Title III of the USA Patriot Act of 2001; enacted by Pres. Bush on Oct. 26, 2001.
2. The NAIC is a member of the U.S. Treasury Department's Bank Secrecy Act Advisory Group.

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