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Via E-Mail

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Mr. Keith Chapman
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Subject: Refinements General Insurance Prudential Framework, Reinsurance Collateral

Dear Mr. Trowbridge and Mr. Chapman:

On behalf of the 22 members of the Association of Bermuda Insurers and Reinsurers (ABIR) we offer these comments on the “Refinements to the General Insurance Prudential Framework” paper. Our comments are confined to the section which includes a section creating a collateral requirement for domestic insurers with reinsurance liabilities from reinsurers which are not specifically approved by APRA. We oppose the creation of the new collateral requirement and in this submission explain why such a proposal is not necessary.

Bermuda Reinsurers

Although Bermuda’s reinsurance market is less than 30 years old, ABIR members now make up 13 of the top 40 reinsurers in the world according to *Standard and Poor’s Global Reinsurance Highlights, 2006 edition*. ABIR’s members wrote global premium of \$56 billion on a surplus base of \$64 billion at year end 2006. Although we do not have specific Australian market share data, we can provide you with market share statistics from the United States and Europe which are meaningful in depicting our importance to the global reinsurance market. The international Class 4 reinsurers of Bermuda have:

1. 25% of the US property and casualty reinsurance market (NAIC Schedule F Data)
2. 40% of the US property catastrophe market (Broker Surveys)
3. 27% of the European broker placed reinsurance market (Broker Surveys)
4. 40% of the European property catastrophe market (Broker Surveys)
5. 30% of the global reinsurance market (Standard and Poor’s).

ABIR members are all regulated as Class 4 insurers in Bermuda and as a result are subject to a separate and distinct regulatory regime that meets international regulatory standards as identified by the International Association of Insurance Supervisors (IAIS). The Bermuda regulatory

regime is subject to independent review by the International Monetary Fund's Financial Standards Assessment Program and a new report on the Bermuda regulatory regime will shortly be published. The Class 4 regulatory regime as in effect in Bermuda contains all the strong elements of an effective solvency regulation oversight program: 1) on site financial examinations, 2) fit and proper standards for officers and directors, 3) capital requirements including risk based capital requirements, 4) statutory financial reporting to afford audits of compliance with the solvency regulation requirements; and 5) mandatory stress and scenario testing. Additional provisions will take effect in 2008. Please feel free to contact Mr. Matthew Elderfield, CEO of the Bermuda Monetary Authority (BMA), (or Deputy CEO Jeremy Cox or Chief Actuary Rick Shaw) for an authoritative assessment of Bermuda's prudential regulatory framework for Class 4 reinsurers.

21st Century Trends

Rather than imposition of collateral requirements, the regulatory focus over the last decade has been on abolishing collateral requirements. The United States, France and Portugal are the jurisdictions often cited as currently having long established collateral requirements. France has applied its collateral requirements to both domestic and foreign reinsurers. The European Union's reinsurance directive, which took effect in December of 2007, requires the abolition of collateral requirements within the EU and creates an open market for transaction of reinsurance by reinsurers within the member states. With regard to cross border reinsurance placement, the Directive authorizes a mutual recognition framework. In 2008 each member state is now establishing its own plans for how to treat cross border reinsurers. Generally speaking, it is not expected that EU member states will institute collateral requirements for non EU reinsurers unless the third country jurisdiction itself imposes collateral requirements. The Directive affords a "retaliatory" test option that states non EU reinsurers would be subject to no greater regulatory benefit in the EU than EU reinsurers are afforded in that third country jurisdiction. An Australian collateral requirement therefore would likely lead to a retaliatory collateral requirement in Europe for Australian reinsurers seeking to do business in the EU.

In the United States, the National Association of Insurance Commissioners (NAIC) has committed itself to a substantial overhaul of its collateral requirements. Although the US effort has been arduous, it is expected that by yearend 2008, the NAIC will present to the states a new reinsurance regulatory framework that substantially reduces the existing collateral requirement. It is expected to be replaced with a risk based system based on two critical components: an assessment of the equivalence of reinsurance regulation in the reinsurer's domicile and the financial strength of the reinsurer itself. Ultimately, one of the goals of the US reform is to focus ceding insurers on their obligation to thoroughly evaluate the financial standing of a reinsurer prior to making it a counter party.

The fundamental reinsurance regulatory reform in both the United States and Europe is intended to move those jurisdictions along a path towards mutual recognition. Under the mutual recognition concept, after an assessment of regulatory prudential requirements, transparency and cooperation with another jurisdiction, regulators would choose to recognize that jurisdiction as meeting a regulatory equivalency test that would then allow that jurisdiction's insurers to conduct business in the country on a cross border basis without requirements for additional

regulatory controls over the company in the new market. Bermuda's commitment to meeting international regulatory standards also positions it to meet mutual recognition requirements as they will be developed by the International Association of Insurance Supervisors, the US, the EU or other jurisdictions. The Bermuda Monetary Authority (BMA) would likely welcome the opportunity as well to explore a mutual recognition framework with APRA.

In summary, a proposal such as APRA's to impose new collateral requirements on non-Australian reinsurers is contrary to the prevailing regulatory wisdom with regard to assessments of reinsurance recoverable liabilities. Australia's imposition of collateral requirements would be seen as: counterproductive to an international effort to create a converged regulatory standards regime built around the work of the IAIS; detrimental to consumers because of increased costs and the potential for a restricted market; a retrenchment to the days of regulatory protectionism designed to favor a domestic reinsurance market, over a competitive, diverse international cross border reinsurance market; and ignoring the desire of regulators around the world to recognize that their consumers would benefit from a mutual recognition framework that enhances competition in markets by opening borders to freer trade.

Obligations of the Cedent

In the United States it has been recognized that collateral requirements imposed on non-US authorized reinsurers have had the effect of penalizing financially strong reinsurers. It has also been recognized that the regulatory mandate of collateral from reinsurers has also led to less than adequate due diligence by the ceding insurers in assessing the credit quality of the reinsurer. Why evaluate the credit quality of the non-US reinsurer when you get full collateral from either the AA reinsurers or the BBB reinsurers? In addition, the US research has identified that the greatest credit risk arises from the BBB rated US reinsurers and not the foreign reinsurers.

The New York Insurance Department's collateral alternative proposal is one that specifically includes recognition of cedent's obligation with requirements for the ceding insurer to demonstrate its effective due diligence in assessing the financial strength of its counterparties. More tools are available today than ever before to help a cedent evaluate the credit standing of its reinsurers. In addition, the move to global convergence in regulatory standards creates an additional pathway in which regulators themselves can become comfortable with the regulatory competency and legal standards imposed as part of a prudential regulatory framework.

International Trade Agreements

International trade commitments on market access have often been cited in the US debate as one reason why the US will need to do away with collateral requirements. In Australia, APRA should review its own international trade agreements to see if the imposition of collateral on non-authorized reinsurers will be viewed as a violation of trade commitments already in place. A state can make its case that a collateral requirement is part of a prudential framework and therefore immune from the trade agreement, but that case will be increasingly difficult to make with the establishment of global solvency regulation standards via the IAIS and the abolition of the collateral framework in Europe and the United States.

Cost and Capacity Affects on Reinsurance

The Insurance Council of Australia in its letter to APRA dated September 28 noted its concerns about the possible affects of the collateralization proposal on the availability and affordability of reinsurance in Australia. Anti-trust rules prevent us from surveying members to determine their response to proposed regulatory initiatives. We can not collect market information from competitors in the market. We can, though, point to published statistics which we believe help underscore the IAC's concerns. According to data we have, 13 reinsurers are currently approved by APRA. Two of those reinsurers are now owned by others on the list and an additional one is in runoff. That leaves a total of 10 reinsurers as currently authorized. (We would welcome an opportunity to review any updated APRA approved reinsurer list that you might have available.)

Of the 13 approved APRA reinsurers, 11 are on the Standard and Poor's list of the top 40 global reinsurers as reported in the *Standard and Poor's Global Reinsurance Highlights Report for 2006*, published in 2007. All five of the top reinsurance groups as identified by Standard and Poor's have subsidiaries currently approved in Australia. The APRA approved reinsurers (when counting them with their groups in the S and P chart) account for about 60% of the global reinsurance premium reported. The APRA proposal imposes costs on both the currently authorized reinsurers and on the unauthorized reinsurers.

First, here is a summary of market impact concerns about the impact of the APRA proposal on unauthorized reinsurers and their cedents:

1. The companies missing from the APRA approved list are: the Japanese, Bermudian, and smaller US and EU reinsurers. These are significant market players.
2. Regulators, cedents and other stakeholders have long observed that the reinsurance market tends to oligopoly. By disqualifying the other 27 reinsurers on the S and P list you put the Australian ceding insurer in the difficult position of choosing from a concentrated pool of the largest reinsurers, rather than achieving the benefits of diversification through reinsurance placements with a larger group of independent reinsurers.
3. The Bermudian reinsurers are new and growing reinsurers in the global markets and they represent the best chance for diversification of a concentrated reinsurance market. None of the ABIR members are on the list of APRA approved reinsurers that has been supplied to us by the IAC.
4. The effect of the APRA proposal is to constrict rather than to expand the Australian reinsurance market. Furthermore, the affect is to concentrate the market in a handful of the world's largest reinsurance players.
5. The effect of the APRA proposal will likely to be to increase reinsurance costs for Australian ceding insurers. The testimony from the United States indicates that collateral costs range from between 15 and 100 basis points based on the credit standing of the reinsurer and the type of collateralization instrument used. These costs will be passed onto consumers.

6. The Bermudian reinsurers also specialize in property catastrophe reinsurance markets. We have an estimated 40% of the US and EU share of the property catastrophe market and are recognized as leading innovators in property catastrophe products. Australia, with its cyclone (hurricane) and earthquake propensity, is a market in need of ready access to property catastrophe reinsurance. Furthermore, since catastrophe events themselves can be destabilizing on a company, it is longstanding practice to assume that an insurer benefits from placing its reinsurance risk for catastrophic risks with reinsurers that are not subject to the same domestic loss scenarios to which they themselves are subject.
7. Bermuda's reinsurers have been tested with the worst of the events that mankind and Mother Nature can throw at us, having proved to be quite resilient in spite of record setting losses from the World Trade Center tragedy and the 2005 sequence of Hurricanes Katrina, Rita and Wilma. Bermuda's reinsurers alone paid for an estimated 30% of the record setting US 2005 Katrina, Rita and Wilma losses – an amount equal to \$22 billion US. Bermuda's Class 4 reinsurers are viewed as very highly capitalized companies.

There are many business reasons to establish a presence in Australia if you are a large insurer. It gives you excellent client access and allows for long term trading relationships to be established. But if you are new or medium sized reinsurer it does not likely make sense to establish an Australian presence and segregate and locate capital in the jurisdiction. ABIR's 22 members have underwriting operations in Bermuda that specialize in property catastrophe business and many of them have US and EU operating subsidiaries that focus on those very large important markets. As a general rule, though the capital is centralized in the Bermudian parent so that maximum flexibility is achieved in taking advantage of business opportunities. This is also the practice of the longest established and largest global reinsurers. The effect of collateral or authorized subsidiary requirements with the intent to localize capital is to segregate capital and to make capital less flexible and to increase the costs of doing business. It should be understood that you can write more business from one single capital pool, than if you were to subdivide that capital pool into ten separate pots of funds. With each separate pot comes associated business, tax and regulatory costs that as a whole diminish the amount of reinsurance that can be written from the same amount of total capital available to support the business.

Secondly, with regard to the large foreign groups with approved subsidiaries in Australia, the APRA proposal imposes significant new costs on them as well. It should be noted that since each of these subsidiaries likely relies on its parent for affiliated reinsurance support, that each would likely be subject to significant new collateral requirements in their own right. This new requirement for affiliated reinsurance collateralization bears separate study on the impact of that requirement on the market appetite of these very large reinsurers. The regulatory proposal presents these reinsurers with a Hobson's choice. Essentially these large carriers are going to be subject to collateralization if they compete in Australia without authorization and will also be subject to collateralization of their own retrocessional business if they are APRA authorized. The reinsurers could choose to drop their APRA authorization and conduct business on a non-authorized basis rather than commit capital in both an Australian subsidiary and for collateralization of affiliated retrocessional liabilities.

Assessment of the Risk as Described by APRA

In the Chapter 2 Reinsurance Proposals as published by APRA, there is a short discussion of the rationale for the collateral proposals. The suggestion is that there is “greater risk” to Australians from a ceding insurer’s utilization of non-Australian reinsurance. We challenge APRA to produce the evidence for this statement. The international reinsurance sector has an excellent track record in financial integrity and soundness. In Bermuda’s young reinsurance market, we know of no examples of the failure of a Class 4 reinsurer that has led to reinsurance claims going unpaid in Australia. Reinsurers are very well capitalized and have operated at low premium to surplus ratios thus affording a capital cushion. Bermuda’s risk based capital standard in turn affords the regulators new additional tools to compel additional capital as part of ongoing prudential regulatory review. The carriers that have gone into runoff are known to be carriers with sufficient assets to pay claims and thus they are in a solvent runoff mode.

In this section we provide a point/counterpoint to statements made in the APRA paper:

“In the event of the insolvency of a non-APRA authorized reinsurer, parties located in its home domicile are likely to receive favorable treatment in liquidation.”

This is simply untrue with regard to Bermuda reinsurers. Bermuda’s Class 4 reinsurers major markets are external to Bermuda. They serve global markets, by definition their assets will be used to manage international client liabilities and in the event of insolvency they will be wound up in such a way as to treat global ceding insurers equitably. There is no “home team” to which to provide an advantage. Even if there were a “home team”, insolvency statutes do not allow for one group of cedents to be advantaged over another.

“In the event of the insolvency of an Australian insurer, there may be circumstances where the recoverables from its reinsurers are not readily accessible in Australia, owing to legal impediments to the repatriation of the recoveries to the insurer’s Australian liquidator.”

If the recoverables are legally due to the ceding insurer, those recoverables will be paid pursuant to the contract. The non-Australian liquidator stands in the shoes of the insolvent reinsurer and will have to honor contractual obligations to the Australian ceding insurer to the extent that there are legitimate and there are sufficient funds to pay those obligations. International treaty agreements (*The New York Convention on the Recognition and Enforcement of Foreign Arbitral Awards*) already exist with regard to the enforceability of arbitration awards and all the leading jurisdictions are subject to that treaty. A similar treaty on court awards, known as the *Hague 2005 Convention on Choice of Courts Agreements, Hague Conference on Private International Law*, is now pending with jurisdictions considering its ratification.

“It is more difficult for APRA to monitor the status of non-APRA-authorized reinsurers than local reinsurers and APRA has no jurisdiction, on behalf of policyholders and claimants, over non-authorized reinsurers.”

This is simply not true in the information age of the 21st century. APRA has access to the same independent insurance claims ratings of the reinsurers as do the ceding insurers. In addition, APRA has access to regulatory information from the reinsurer’s home domicile. Significant time and effort has been spent in recent years to develop memorandums of

understanding that allow confidential regulator to regulator information sharing. APRA has sufficient resources to monitor the financial standing of the 40 largest reinsurers in the world which write nearly the entire reinsurance market.

“There are additional costs and risks in enforcing contracts against reinsurers that have no legal representation in the Australian jurisdiction.”

If APRA is representing an insolvent Australian ceding insurer in a collection action against a non-Australian reinsurer it has assumed the same rights and obligations under those reinsurance contracts as the cedent had. Any expenses associated with the collection were contemplated at the time the reinsurance agreement was entered into. The benefits to the Australian consumer of a competitive, global reinsurance market more than offset the costs to APRA for managing an insolvency with reinsurance collections from abroad.

Conclusion

In conclusion, we would urge APRA to reconsider the proposed regulations and to not go down the path of creating the first new collateral requirements in a major established insurance market in the last nearly 60 years. We make these concluding and summary points:

1. APRA has been a leader in designing new prudential regulatory and capital frameworks and in developing IAIS global standards. As such APRA should recognize that a mutual recognition framework is one that would meet its future regulatory goals, not outdated non-authorized collateral requirements. The collateral requirements are fundamentally contrary to APRA’s work in creating a mutual recognition regulatory framework via the IAIS.
2. Based on a review of reinsurers authorized in Australia, it is possible that the imposition of collateral requirements on an “either be authorized or post collateral basis” may shrink the number of reinsurers available to the Australian ceding insurance community. If this happens, the likely affect on the Australian market of fewer reinsurers is increased cost and increased chance of insolvency due to reduced utilization of reinsurance.
3. As a market prone to natural disaster risk, Australia is particularly in need of the property catastrophe reinsurance products to which the Bermuda based companies in ABIR’s membership excel. The collateral requirements proposed by APRA would apply to these short tail property catastrophe liabilities even when it is demonstrably clear that the ceding insurer is in an excellent position to judge the claims paying capabilities of its counterparties and can evaluate whether the reinsurer will be around to pay the claims during the roughly 24 month tail that follows a cyclone (hurricane) event.
4. The imposition of collateral on affiliated reinsurance transactions, may cause approved reinsurers to reconsider their established Australian operations. It may be more capital efficient to operate from abroad and post letters of credit than to keep the Australian operation, meet in country capital requirements and post collateral for retrocessions.
5. Establishment of collateral does not address concerns of the Australian regulator with regard to reinsurance collections. Collateral does not override contract requirements for the terms of the conditions of the contract to be honored prior to a claim being paid. If

the reinsurer has a legitimate reason to deny a claim or to rescind coverage, and the arbitration panel or court recognizes the legitimacy of the reinsurer's position, the Australian ceding insurer will not be able to draw down the collateral held from the reinsurer.

6. The statement in the APRA document on the difficulties in collecting from non-Australian reinsurers or the "home court advantage" that will be afforded the reinsurer in its country of domicile simply are incorrect when applied to the Bermudian reinsurance market.
7. Bermuda is a self-governing territory of the United Kingdom with a legal framework with much in common with that of Australia. The ultimate court to resolve disputes in Bermuda is the Privy Council in London. British law provides a firm foundation for dispute resolution with Bermuda reinsurers.
8. We'd recommend that APRA consult with the Bermudian Monetary Authority directly about regulatory standards in Bermuda and about any interest in regulatory cooperation agreements that could provide assurances to APRA about the feasibility of future mutual recognition agreements between the two countries that would likely aid in cross border business activity.

We appreciate the opportunity to file these comments and would be happy to address future questions that APRA has about our comments.

Sincerely,



Bradley L. Kading
President and Executive Director
Association of Bermuda Insurers and Reinsurers