Hogan Lovells

EU/U.S. Covered Agreement: What's Next?

Introduction

On January 13, 2017, representatives of the European Union and the United States of America issued a joint statement announcing that they had successfully concluded negotiation of an agreement (the "Agreement" or "Covered Agreement") that both parties contend "will ensure ongoing robust insurance consumer protection and provide enhanced regulatory certainty for insurers and reinsurers operating in both the U.S. and the EU."[1] According to the joint statement, the Agreement constitutes a "covered agreement" within the meaning of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 ("Dodd-Frank") in the U.S. and an "agreement" under Article 218 of the Treaty on the Functioning of the European Union in the EU.[2]

The Agreement addresses three areas of prudential insurance regulation important to internationally active (re)insurers: (1) reinsurance; (2) group supervision; and (3) the exchange of information between insurance supervisors. As discussed more fully below, key aspects of the Agreement are meant to provide EU-based (re)insurers with relief from U.S. collateral requirements, to provide U.S.-based (re)insurers with relief from EU local presence requirements, and to free U.S. insurance groups operating in the EU from EU worldwide group capital, solvency, reporting, and governance requirements under the EU "Solvency II" Directive and applicable implementing legislation ("Solvency II").[3] The group supervision and reinsurance provisions are conditioned upon one another.[4] Therefore, without collateral relief for EU-based entities, there is no local presence or worldwide group supervision relief for U.S.-based entities, and vice-versa.

Initial reaction in the U.S. has been swift and generally positive among the insurance industry. American Insurance Association ("AIA") President and CEO Leigh Ann Pusey, for example, praised the agreement as "both a win for U.S. insurers and reinsurers competing in the EU and a win for the U.S. state-based system of insurance regulation."[5] National Association of Insurance Commissioners ("NAIC") President and Wisconsin Insurance Commissioner Ted Nickel expressed greater skepticism, however, stating, "As most state regulators were not allowed to participate in the process, the NAIC is coordinating a thorough review of the agreement to ensure consumer protections are not compromised through the preemption of state law," and that "[o]f great concern is the potential to use this agreement as a backdoor to force foreign regulations on U.S. companies."[6] In the EU, chairman of the European Insurance and Occupational Pensions Authority ("EIOPA") Gabriel Bernardino welcomed the Agreement, considering it "a further step in the successful cooperation between the European Union und U.S. insurance supervisors […] enhancing regulatory certainty and opportunities for (re)insurers on both sides of the Atlantic for the benefit of consumers".[7]

This article provides some background on the impetus behind the Agreement, summarizes its substantive terms, and discusses issues related to its implementation.

Background

U.S. Collateral Reform

Model Law Amendment and Adoption

Historically, under U.S. state insurance laws and regulations, in order for a U.S. cedent to receive financial statement credit for risk ceded to a reinsurer not licensed in the U.S., the reinsurer must post collateral in a U.S financial institution equal to 100 percent of its financial obligation to the cedent. From U.S. state regulators' perspectives, this requirement helped to ensure that claims would be paid when they came due, and protected the solvency of the ceding insurer. From the perspective of non-U.S. reinsurers, however, such collateral requirements unnecessarily tie up capital that otherwise could be used for other purposes, "restrict the ability to manage risk globally, restrict reinsurance capacity in the United States, and . . . increase cost for U.S. consumers."[8]

To address such concerns, and as part of its "Solvency Modernization Initiative," in November 2011 the NAIC adopted revisions to its *Credit for Reinsurance Model Law* (#785)[9] and *Credit for Reinsurance Model Regulation* (#786)[10] that, if enacted by the states, would reduce or eliminate collateral requirements for non-U.S. reinsurers, provided that the reinsurer were licensed by and domiciled in a "qualified jurisdiction," and "certified" by the ceding insurer's U.S. domiciliary regulator. According to the NAIC, as of January 12, 2017, 34 states and the District of Columbia have adopted the 2011 revisions to Model Law #785, and 28 have adopted the 2011 revisions to Model Regulation #786.[11] Effective January 1, 2019, adoption of these revised models will become a required standard under the NAIC Financial Regulation Standards and Accreditation Program,[12] virtually assuring their adoption in most, if not all, of the remaining U.S. jurisdictions.[13]

Qualified Jurisdictions and Certified Reinsurers

Factors considered in evaluating whether a non-U.S. reinsurer's domiciliary jurisdiction is a "qualified jurisdiction" include, among others, the history of performance by reinsurers in the jurisdiction, and whether the jurisdiction adequately and promptly enforces final U.S. judgments or arbitration awards.[14] To date, qualified jurisdictions include Bermuda, France, Germany, Ireland, Japan, Switzerland, and the United Kingdom.[15]

Approximately three dozen reinsurers have been certified by one or more U.S. jurisdictions, with additional applications pending. Under Model Law #785, where an applicant for certification already has been certified as a reinsurer by an NAIC-accredited jurisdiction, states have the discretion to defer to the certification granted, and the collateral requirements assigned, by that jurisdiction through a "passporting" process.[16] The extent of collateral relief granted depends on a number of considerations, including the assuming reinsurers' financial strength ratings from at least two acceptable rating agencies.[17] Most commonly, certified reinsurers have been required to post collateral in the 10-to-20 percent range, although a few have been required to post as much as 50 or 75 percent collateral. According to information available on U.S. state regulators' websites, to date, no certified reinsurer has been granted complete relief from collateral requirements.[18]

Federal View

According to the Federal Insurance Office (FIO), these reforms are not enough. Established under Dodd-Frank, FIO is authorized, among other things, “to monitor all aspects of the insurance industry, including identifying issues or gaps in the regulation of insurers that could contribute to a systemic crisis in the insurance industry or the United States Financial System”[19] and “to coordinate Federal efforts and develop Federal policy on prudential aspects of international insurance matters, including . . . assisting the Secretary in negotiating covered agreements[.]”[20] In executing those responsibilities, FIO has expressed concerns with states’ implementation of the revised NAIC Model Law and Regulation, including that one state’s determination “of the adequacy or the equivalence of regulation by another nation would not bind other states,” and whether states would apply the Models in a uniform manner.[21] Accordingly, in December 2013, FIO recommended that the U.S. pursue a covered agreement with the EU addressing reinsurance collateral requirements.[22]

EU Regulation of Reinsurance, Insurance Group Solvency and Insurance Group Supervision

Background

In the EU, the Covered Agreement will have implications for the regulation of insurance under Solvency II in three principal areas. Each of these areas relates to a point on which Solvency II conferred powers on the European Commission to decide whether the regime of a non-EEA country[23] is equivalent to the Solvency II regime:

a) *Article 172: Eligibility of reinsurer:* Generally an EEA cedent may only take credit for reinsurance provided by a non-EEA reinsurer if the non-EEA reinsurer is rated at least BBB or provides collateral. However, if the non-EEA reinsurer is from a jurisdiction that the European Commission decides has a reinsurance solvency regime that is equivalent to Solvency II then neither the rating nor the collateral would be required.

b) *Article 227: Group solvency*: EEA (re)insurers are required to prepare a consolidated capital calculation taking into account direct and indirect subsidiaries of their top EEA insurance holding company. In producing this consolidated capital calculation, Solvency II rules must be used, even for determining the capital requirements of subsidiaries outside the EEA. However, if a subsidiary is in a jurisdiction that the European Commission has decided has a group solvency regime that is equivalent to Solvency II then the capital requirement of that subsidiary determined under its local rules (rather than a different requirement recalculated under the Solvency II rules) can be used.

c) *Article 260: Group supervision*: In addition to supervision at the level of the top EEA insurance holding company, an EEA (re)insurer is generally subject to group-wide supervision at the level of its top insurance holding company, even if that company is located outside the EEA. This group-wide supervision is required to be carried out by an EEA regulator under the Solvency II rules. However, if the top insurance holding company is in a jurisdiction that the European Commission has decided has a group supervision regime that is equivalent to Solvency II then the group supervision by the regulator in that jurisdiction can be relied on, and the Solvency II group supervision will only apply at the level of the top EEA insurance holding company.

The goal of giving the European Commission powers to decide that other jurisdictions are equivalent to Solvency II in each of these areas is "to avoid unnecessary duplication of regulation".[24]

The European Commission has already granted the U.S. provisional equivalence (until 2026) for group solvency under Article 227 (along with Japan, Australia, Brazil, Canada and Mexico, and along with Bermuda and Switzerland which have been granted permanent equivalence). However, it has not granted the U.S. equivalence for reinsurance solvency under Article 172 (for which only Bermuda, Switzerland and Japan have been declared equivalent, Japan on a temporary basis until 2021) or group supervision under Article 260 (for which only Bermuda and Switzerland have been declared equivalent). In the past this has been explained on the basis that insurance regulation in the U.S. is carried out at state level, rather than federal level, so that an equivalence decision in relation to the U.S. would require analysis of the laws of every U.S. state.

The likely effect of the Covered Agreement is that the European Commission will now decide that the US is equivalent for reinsurance solvency, under Article 172, and for group supervision, under Article 260, in each case subject to the same conditions as are laid down in the Covered Agreement. It remains to be seen whether equivalence will be granted immediately, or whether the European Commission will wait to see progress made by the U.S. in implementing the Covered Agreement before making an equivalence decision.

In this context the Covered Agreement will be an agreement of the EU under Article 218 of the Treaty on the Functioning of the European Union, and also an agreement under Article 175 of Solvency II. Article 175 is a means by which the EU may enter into an agreement with a non-EEA country on the means of exercising supervision of a non-EEA reinsurer operating within the EEA and an EEA reinsurer operating in the non-EEA country. Such an agreement can pave the way for an equivalence decision under Article 172.

Reinsurance Provided by Non-EEA Reinsurers

It is useful to consider in particular past and present EEA rules on reinsurance supervision. This has been an area where U.S. reinsurers have recently been in doubt regarding their ability to operate in the EEA, and particularly in Germany.

Before 2016

Until the EU enacted the "Reinsurance Directive"[25] in 2005, the supervision of reinsurers was not subject to a common regulatory framework within the EU/EEA ("EEA"). The Reinsurance Directive included a general rule on the treatment of reinsurers having their head office outside but conducting reinsurance activities within the EEA. However, this rule did not aim at drawing up certain operational requirements for such reinsurers. It was only intended to ensure that each member state was prohibited from treating non-EEA reinsurers more favorably than reinsurers domiciled within the respective member state. Therefore, the member states were still free to determine their own requirements which non-EEA reinsurers had to fulfill in order to conduct reinsurance business in their jurisdictions.

Some member states required non-EEA reinsurers to establish a local branch (also referred to as a "local presence") as a condition of operating in that member state, and to deposit assets within the member state as a form of collateral for their obligations. These requirements were sometimes subject to exceptions where certain conditions were satisfied.

For instance, Germany imposed a general requirement for a local presence, but allowed two exceptions:

(a) *§ 121i exception*: According to § 121i para. 1 sentence 3 of the German Insurance Supervision Act ("VAG") as it existed prior to 2016, non-EEA reinsurers were allowed to conduct reinsurance business in Germany from their respective domicile if i) these reinsurers were authorized to conduct reinsurance business in their domicile country where they had their head office, ii) they were supervised by way of internationally recognized standards, and iii) a satisfactory cooperation between the competent supervisory authority of this country and the German Federal Financial Supervisory Authority ("BaFin") could be ensured. Under this model, the reinsurer could make use of brokers operating in Germany, but would not itself have to establish a local German presence.

(b) *Correspondence reinsurance exception*: A second exception was for "correspondence-type (re)insurance" ("Korrespondenzversicherung"), where the reinsurance was conducted from the home domicile exclusively by telephone, fax, email and post. This exception would only apply where the initiative for the contract came from the German cedent, and the non-EEA reinsurer did nothing to target the German market, including through German brokers.

On the basis of the § 121i exception, BaFin acknowledged several U.S.-based reinsurers operating in Germany without having established a local presence.

The position in the UK was (and continues to be) that non-EEA reinsurers may provide reinsurance to UK insurers without an EEA authorization or a local presence provided they do not carry on business in the UK. This means ensuring that all the activities relevant to their reinsurance contracts (including negotiating contracts, receiving premiums and paying claims) are carried on from the reinsurer's domicile country.

2016 to Present

From 1 January 2016, Solvency II introduced the new requirement described above under which an EEA cedent is only permitted to take credit for uncollateralized reinsurance provided by an unrated non-EEA reinsurer if the non-EEA reinsurer is situated in a jurisdiction that the European Commission has decided has a reinsurance solvency regime equivalent to Solvency II. While this new requirement resulted in considerable activity to set up new collateral arrangements where necessary, it was not regarded as imposing an undue burden on the industry.

However, in Germany this requirement was interpreted as having wider and unexpected consequences – in particular, for U.S.-based reinsurers. The § 121i exception was removed and replaced by a new rule in § 67 para. 1 sentence 2 VAG. The latter provides that reinsurers domiciled in a non-EEA country may conduct reinsurance business in Germany from their head office without an authorization once the European Commission has adopted an equivalence decision according to Article 172 of the Solvency II Directive applying to the respective country.

In the absence of such a decision on the U.S. reinsurance solvency regime, the U.S.-based reinsurers whose activities in Germany had previously been permitted under the § 121i exception were informed by BaFin that, in order to continue their business, they would need to establish a branch in Germany and would be required to obtain a German authorization for that branch. In other

words, because the U.S. was not equivalent under Article 172, Germany was imposing a requirement for a local presence. BaFin also issued an interpretative decision on August 31, 2016 setting out the change of the requirements for non-EEA reinsurers operating (or intending to operate) in Germany.[26]

This was a controversial application of Article 172, whose main purpose is to determine whether EEA cedents should be permitted to rely on uncollateralized reinsurance provided by unrated non-EEA reinsurers. As written, equivalence under Article 172 is not a condition of a reinsurer being authorized to operate in the EEA. However, since Solvency II allows EEA member states the right to specify the conditions on which non-EEA reinsurers may operate in their member state, it was open to Germany to make it a condition that the non-EEA reinsurer must be from a country that is equivalent under Article 172 or that it would otherwise have to establish a German branch and obtain authorization.

However, some relief was still available to US reinsurers operating in Germany. Although the § 121i exemption had been removed, the correspondence reinsurance exception was still available. Accordingly, BaFin agreed to allow US reinsurers to use this mode of entering into reinsurance contracts as a way of dealing with the renewal of business for 2017.[27] However, it can be assumed that this would not be acceptable for BaFin year on year or if it would mean that the German business of the non-EEA reinsurer would significantly grow.

Impact of the Covered Agreement on the German Rules

Following the publication of the Covered Agreement, BaFin wrote to the FIO to confirm that it was willing to suspend the local presence requirements for U.S. reinsurers as soon as the Covered Agreement entered into legal force. It said that this would remain its position unless it receives serious statements of one of the parties (the EU or the U.S.) that the Agreement will not come into force or will not continue in force. It is notable that it has said that it is willing to do this even before the European Commission has made a formal decision on equivalence for reinsurance supervision under Article 172.

This will come as some relief to U.S. reinsurers operating in Germany without a local branch, as they may otherwise have been forced to establish a German branch, and obtain authorization, or to cease business in Germany. However, this relief remains subject to progress on implementation of the Covered Agreement, as BaFin has made clear that it may reverse its position if the Covered Agreement does not come into or continue in force.

Covered Agreement

Authorization

Dodd-Frank jointly authorizes the Secretary of the Treasury ("Treasury") and the United States Trade Representative ("USTR") to negotiate and enter into covered agreements on behalf of the U.S. A "covered agreement" is "a written bilateral or multilateral agreement regarding prudential measures with respect to the business of insurance or reinsurance that – (A) is entered into between the United States and one or more foreign governments, authorities, or regulatory entities; and (B) relates to the recognition of prudential measures with respect to the business of insurance or reinsurance that achieves a level of protection for insurance or reinsurance consumers that is

substantially equivalent to the level of protection achieved under State insurance or reinsurance regulation."[28] A level of protection under a covered agreement is "substantially equivalent" to the level of protection under state regulation only if "the prudential measures of a foreign government, authority, or regulatory entity achieve a similar outcome in consumer protection as the outcome achieved under State insurance or reinsurance regulation."[29]

On November 20, 2015, Treasury and the USTR notified the Committee on Financial Services and the Committee on Ways and Means of the U.S. House of Representatives, and the Committee on Banking, Housing, and Urban Affairs and the Committee on Finance of the U.S. Senate (the "Congressional Committees"), of their intention to commence negotiations to enter into a covered agreement with the EU. Referencing the then-impending implementation of Solvency II, they asserted that such a covered agreement "would level the regulatory playing field for U.S.-based insurers and reinsurers operating there, and further confirm that the existing U.S. insurance regulatory system serves the goals of insurance sector oversight, policyholder protection, and national and global financial stability."[30]

In relation to the EU, Article 175 of Solvency II authorizes the European Commission to submit proposals to the Council of the European Union for the negotiation of covered agreements. It also specifies the scope and the goals of such agreements. In particular, they are intended to ensure, under conditions of equivalence of prudential regulation, effective market access for reinsurers in the territory of each contracting party and provide for mutual recognition of supervisory rules and practices on reinsurance. The actual process of the negotiation and conclusion of the Covered Agreement is governed by the rules set out in Article 218 of the Treaty on the Functioning of the European Union. As a consequence of this, in order to formally conclude the Covered Agreement, the Council has to adopt a decision on its conclusion which is subject to the European Parliament's consent. The Covered Agreement is expected to pave the way for the European Commission to make an equivalence decision on reinsurance supervision under Article 172.

<u>Negotiation</u>

The negotiations commenced in February 2016. In the U.S., state insurance regulators and federal lawmakers alike were sometimes critical of the process for a perceived lack of transparency.[31] Be that as it may, on January 13, 2017, having reached an Agreement, Treasury and USTR provided the final text of the Agreement to Congress in accordance with Dodd-Frank requirements. Dodd-Frank provides that the Agreement may enter into force with respect to the United States following the expiration of a 90-calendar day "layover" period, which is due to expire on April 13, 2017. The EU also will follow the necessary steps, involving the Council of the European Union and the European Parliament, and in accordance with the Treaty on the Functioning of the European Union, "to sign and formally conclude the Agreement."[32] The Agreement itself provides that it shall enter into force seven days after the EU and the U.S. exchange written notifications certifying that they have completed their respective internal requirements or procedures or "on such other date as the Parties may agree."[33]

<u>Potential Preemption</u>

Dodd-Frank provides that state insurance laws, regulations, administrative rulings, and other state insurance measures may be preempted by federal law, and thereby rendered unenforceable by the states, if, and to the extent that, the FIO Director determines that the measure: (1) results in less

favorable treatment of a non-U.S. (re)insurer domiciled in a foreign jurisdiction that is subject to a covered agreement than a U.S. (re)insurer; and (2) is inconsistent with a covered agreement.[34]

Before a state insurance measure may be preempted, the FIO Director must notify and consult with the appropriate state and the USTR, and publish a notice of the proposed preemption in the *Federal Register* for public comment.[35] If the Director determines that the conditions for preemption are satisfied, the Director must notify the appropriate state and the Congressional Committees, and must establish "a reasonable period of time" of at least 30 days, before the determination will become effective.[36] Upon the expiration of that time period, the determination becomes effective provided that "the basis for such determination still exists."[37] The Director must then publish a second notice in the *Federal Register* that includes the effective date of the preemption, and notify the appropriate state.[38] Any such determination by the Director, and any resulting preemption of state insurance measures, "shall be limited to the subject matter contained within the covered agreement involved and shall achieve a level of protection for insurance or reinsurance consumers that is substantially equivalent to the level of protection achieved under State insurance or reinsurance regulation."[39] The FIO Director's determinations in that regard are subject to *de novo* judicial review.[40]

The Agreement: Terms and Implementation

Reinsurance

Relief from Collateral and Local Presence Requirements

Subject to certain conditions, the Agreement prohibits insurance regulators from imposing collateral and local presence requirements for U.S. reinsurers operating in the EU, and for EU reinsurers operating in the U.S., as conditions for cedents to recognize regulatory accounting credit for reinsurance, where such requirements would result in less favorable treatment of non-domestic assuming reinsurers than domestic assuming reinsurers.

Conditions for Relief

The conditions that must be satisfied for this relief to take effect are highly probative of whether, as claimed, the Agreement "continue[s] to ensure a high standard of protection for U.S. and EU consumers."[41] They include specified minimum capital and surplus requirements, calculated according to the methodology of the assuming reinsurer's home jurisdiction, as well as a minimum solvency capital requirement ratio ("SCR") of 100% or risk-based capital ("RBC") ratio of 300% Authorized Control Level for assuming reinsurers headquartered or domiciled in the EU or U.S., respectively, as confirmed by the reinsurer's domiciliary regulator on an annual basis. In the case of reinsurance provided by a Lloyd's syndicate, the capital requirements and SCR ratio are assessed at the level of Lloyd's as a whole, taking into account the Lloyd's Central Fund, and not at the level of the syndicate. The assuming reinsurer must agree to provide prompt written notice and explanation to the ceding insurer's home regulator if it falls below the specified capital and surplus levels or SCR/RBC ratios, or if "any regulatory action is taken against it for serious noncompliance with the law."[42] In addition, the assuming reinsurer must consent in writing to the jurisdiction of the courts in the ceding insurer's home territory, to the appointment of that territory's regulator as its agent for service of process purposes, and to pay all final judgments obtained by the ceding insurer that are enforceable where the judgment was obtained. Further, it must agree to provide collateral for 100% of its liabilities attributable to a reinsurance agreement with a ceding insurer if it resists enforcement

of a final judgment or arbitration award properly enforceable under the law of the territory where the judgment or award was obtained.[43]

Also included in the conditions for collateral and local presence relief are certain assuming reinsurer reporting requirements to the non-domiciliary insurance regulator. Upon request, the assuming reinsurer must provide annual audited financial statements, solvency and financial condition reports or actuarial opinions filed with its domestic regulator, in each case with respect to the two years preceding entry into the reinsurance agreement and on an annual basis thereafter. Also upon request, prior to entry into the reinsurance agreement and not more than semi-annually thereafter, the assuming reinsurer must provide "an updated list of all disputed and overdue reinsurance claims outstanding for 90 days or more, regarding reinsurance assumed from ceding insurers of the jurisdiction of the ceding insurer" and information regarding its "assumed reinsurance by ceding company, ceded reinsurance by the assuming reinsurer, and reinsurance recoverable on paid and unpaid losses by the assuming reinsurer[.]"[44] The Agreement envisions that this final category of information will allow the cedent's regulator to evaluate whether the assuming reinsurer satisfies another condition for relief: a practice of prompt payment of claims.

In addition, the assuming reinsurer must confirm that it is not presently participating in any solvent scheme of arrangement involving ceding insurers in the cedent's home jurisdiction, and must agree to notify the ceding insurer and its supervisory authority, and to post 100% collateral, should the assuming insurer enter into such an arrangement. Finally, if the ceding insurer is subject to resolution, receivership, or winding up proceedings, it may seek a court order requiring the assuming reinsurer to post collateral for all outstanding ceded liabilities.[45]

Reinsurers in both the EU and the EEA will need to be mindful of these conditions, as they risk losing the relief from collateral and local presence requirements if they do not comply with them. In particular, we note the condition requiring prompt payment of claims, which could be breached if a reinsurer becomes subject to a number of particularly large disputed claims, and as a result the reinsurance recoverables represented by these claims exceed the 15 percent limit imposed by the Covered Agreement. Loss of relief is not automatic, as the Covered Agreement envisages a 90 day notice period during which the position can be rectified by the reinsurer, but the impact of losing the relief could be severe.

Implementation

Under the Agreement, EU member states have 24 months "from the date of signature of this Agreement, provided that the Agreement has been provisionally applied or has entered into force," to eliminate local presence requirements for U.S. reinsurers in accordance with the Agreement.[46] According to Treasury, this also means that "[f]or those U.S. reinsurers that have not yet established a branch or subsidiary but have been operating in the EU, local presence requirements will not be imposed."[47]

The path to implementing relief from U.S. collateral requirements appears to have a longer and more circuitous trajectory. The Agreement provides that from the date of its entry into force or provisional application, whichever is earlier, the United States shall "encourage" each U.S. state to "promptly" reduce the amount of collateral required to allow full credit for reinsurance by 20 percent of the collateral required on the January 1st before the Agreement is signed, and to implement State credit for reinsurance laws and regulations consistent with Article 3 of the Agreement.[48] Notably, however,

the Agreement defers commencing any evaluation of a potential federal preemption determination of U.S. state laws governing collateral requirements and credit for reinsurance for up to 42 months after the Agreement has entered into force, and commits to completing such a preemption determination by as long as five years after that date.[49] Absent preemption, U.S. state credit for reinsurance laws and regulations remain in full force and effect.

In the meantime, U.S. state insurance regulators have made it clear that they intend to conduct "a thorough review of the agreement to ensure consumer protections are not compromised through the preemption of state law[.]"[50] And any preemption determinations ultimately made by the FIO Director would be subject to challenge in court under the non-deferential *de novo* standard of review. Thus, as of this writing, replacing state-based U.S. collateral reform with the terms and conditions in the Agreement appears a potentially distant and uncertain prospect.

As collateral requirements are reduced by implementing measures, the reduction will apply only to reinsurance agreements entered into, amended or renewed on or after the date when the relevant measures take effect, and only with respect to losses incurred and reserves reported thereafter.[51] As a result, reinsurance agreements that are already in effect covering losses incurred in the past will remain subject to the original collateral requirements.

Group Supervision

Worldwide Group Supervision by Respective Domestic Regulator

Subject to certain exceptions, the Agreement provides that a (re)insurance group is subject only to the worldwide prudential insurance group supervision of its "Home supervisory authority," meaning the supervisory authority from the territory in which the worldwide parent of the group is headquartered or domiciled.[52] For U.S. (re)insurance groups operating in the EU, this means that those groups generally will not be subject to EU worldwide group capital, solvency, reporting, or governance requirements that otherwise would apply to (re)insurance groups domiciled or headquartered in jurisdictions not deemed to have a supervisory system "equivalent" to that under Solvency II. Conversely, EU (re)insurance groups operating in the U.S. will be subject to prudential supervision at the worldwide group level only by the relevant EU insurance supervisors.

Notwithstanding this exclusive allocation of supervisory authority at the worldwide group level, supervisors in each jurisdiction still may supervise non-domiciliary groups "at the level of the parent undertaking in its territory."[53] Thus, if a U.S.-based insurance group has one or more group members licensed or domiciled in the EU, for example, the EU supervisor may impose group supervision requirements upon the top-tier entity licensed or domiciled in the EU.

Exceptions to the Rule

The Agreement preserves the ability of "Host supervisory authorities"[54] to step in under certain circumstances. First, where a Home supervisory authority requires a (re)insurance group to submit a worldwide group Own Risk Solvency Assessment ("ORSA"), the Agreement requires the Home supervisory authority to provide a summary of the worldwide group ORSA to Host supervisory authorities if they are members of the group's supervisory college, and to the supervisory authorities of "significant subsidiaries or branches of that group" in those authorities' respective jurisdictions upon request.[55] If no worldwide ORSA is required, the Home supervisory authority must provide

"equivalent documentation."[56] The worldwide ORSA summary or equivalent documentation must include: (1) a description of the (re)insurance group's risk management framework; (2) an assessment of the group's risk exposure; and (3) a group assessment of risk capital and a prospective solvency assessment.[57] If the required documentation "exposes any serious threat to policyholder protection or financial stability in the territory of the Host supervisory authority, that Host supervisory authority may impose preventive, corrective, or otherwise responsive measures with respect to insurers or reinsurers in the Host [supervisory authority's jurisdiction]" following consultation with the group's Home supervisory authority.[58]

Second, Host supervisors may require reports, or request and obtain information, from (re)insurance groups, including at the level of a group's worldwide parent, if the reports "directly relate to the risk of a serious impact" on the ability of group entities to pay claims in the respective territory, or where the information "is deemed necessary by the Host supervisory authority to protect against serious harm to policyholders or serious threat to financial stability or a serious impact on the ability of an insurer or reinsurer to pay its claims in the territory of the Host supervisory authority."[59] Failure to comply with such an information request "may result in preventive, corrective, or otherwise responsive measures being imposed within the Host supervisory authority's territory."[60]

Third, the Agreement imposes conditions upon a (re)insurance group's freedom from the imposition by a Host supervisory authority of group capital assessments or requirements at the worldwide parent level. Specifically, it requires that the group be subject to a group capital assessment by its domestic regulator that "includes a worldwide group capital calculation capturing risk at the level of the entire group, including the worldwide parent undertaking of the insurance or reinsurance group, which may affect the insurance or reinsurance operations and activities occurring in the [Host supervisory authority's territory[.]"[61] And the domestic regulator must have the authority "to impose preventive, corrective, or otherwise responsive measures on the basis of the assessment, including requiring, where appropriate, capital measures."[62]

Fourth, the Agreement does not limit or restrict the ability of EU or U.S. supervisory authorities to exercise supervisory or regulatory authority over entities or groups that own or control credit institutions or depository institutions, or that have banking operations in the respective jurisdiction, or "whose material financial distress or the nature, scope, size, scale, concentration, interconnectedness or mix of activities have been determined could pose a threat to the financial stability" of the respective jurisdiction.[63] As a result, it will still be possible for EEA regulators to exercise group-level supervision over financial conglomerates in accordance with the EU Financial Groups Directive.[64]

Implementation

Under the Agreement, the EU and U.S. are to "provisionally apply" the worldwide prudential insurance group supervision provisions until the date of the Agreement's entry into force.[65] Thereafter, the EU is to apply those provisions "by ensuring" that the relevant authorities follow those provisions. In contrast, the U.S. is to apply those provisions "by using best efforts and encouraging" the relevant authorities to follow the Agreement's group supervision provisions.[66] The Agreement provides for a 60-month period during which supervisory authorities in the EU will not impose a group capital requirement at the level of the worldwide parent of a (re)insurance group with operations in the EU.[67]

This five-year period is significant, because currently, U.S. states arguably do not satisfy at least one of the Agreement's conditions for relief from EU worldwide group supervision. Specifically, although the NAIC has amended its Insurance Holding Company System Regulatory Act in a manner that, as adopted by the states, would authorize state regulators to obtain information from any member of internationally active (re)insurance groups, including information related to capital adequacy,[68] the NAIC is continuing to explore approaches to a U.S. group capital calculation methodology.[69] Thus, even assuming they are inclined to do so, it may take some time before U.S. regulators are in a position to subject (re)insurance groups to a group capital assessment that includes a worldwide group capital calculation capturing risk at the level of the entire group, including the worldwide parent level.

Information Exchange

Finally, the Agreement requires the EU and the U.S. to "encourage" insurance supervisors in their respective jurisdictions to cooperate in the exchange of information. It sets forth in an Annex model provisions for a memorandum of understanding designed to "enhance cooperation and information sharing, while respecting a high standard of confidentiality protection."[70]

Observations

It is interesting to consider a number of factors that may affect the success of the Agreement:

(a) The Agreement was reached during the final days of the Obama Administration. There is no guarantee that a U.S. government under a subsequent Administration will have the political will to use federal preemption power to implement the Agreement in states that do not voluntarily adopt its provisions.

(b) The UK is expected shortly to give notice of its intention to leave the EU, and is not expected to become a member of the EEA. Unless extended by unanimous agreement of all member states of the EU, the notice period will be two years. Once it leaves the EU, the Agreement would no longer apply as between the UK and the US. It is therefore likely that the UK will seek a similar agreement with the US to come into effect when the UK leaves the EU.

(c) Special purpose vehicles ("SPVs") established for the purpose of providing reinsurance funded by the issue of insurance linked securities ("ILS") would not be within the scope of the Agreement. This is because they would not satisfy the minimum requirement of €226m of capital in the EEA or US$250m of capital and surplus in the U.S.[71] Accordingly, SPV reinsurers set up in the EEA would still need to comply with U.S. collateral requirements, and SPV reinsurers set up in the U.S. may have to comply with EEA collateral and local presence requirements. This is likely to prevent meaningful use of SPV reinsurance as between the EEA and the U.S.

There are also some points which remain unclear:

(a) The Covered Agreement has been entered into between the U.S. and the EU. It does not refer to the EEA, which, in addition to the EU countries, also includes Iceland, Lichtenstein and Norway. Our assumption throughout this article is that the Covered Agreement will be

extended to cover these countries, as these countries have adopted Solvency II into their own laws in the same way as EU countries. Clarification on this point may be helpful.

(b) Switzerland is not a member of either the EU or the EEA, so the Covered Agreement will not automatically affect relations between the U.S. and Switzerland.

(c) In this article we have worked on the premise that the EU will implement the Covered Agreement by way of the European Commission making equivalence decisions under Articles 172 and 260 of Solvency II. This would be the easiest way to apply its provisions, as it would be based on existing powers within Solvency II, rather than requiring specific new rules. However, there has been no formal statement on how the EU proposes to implement the provisions, and it is conceivable that the EU plans to implement the provisions by specific rules, rather than making a general declaration of equivalence.

Conclusion

In many respects, the successful conclusion of Agreement negotiations represents the beginning – not the end – of what could prove to be a lengthy process. For the next several years, U.S. states have the option of working to implement credit for reinsurance collateral reform consistent with the Agreement, but they are not required to do so. The possibility of federal preemption may prove a powerful motivator. Alternatively, at least some states could decide to challenge any preemption determinations in court. Similarly, there is a potentially long flight path for U.S. state insurance regulators to adopt a group supervision paradigm that satisfies the Agreement's requirements. Time will tell whether the exceptions to the principle of domestic worldwide prudential insurance group supervision set forth in the Agreement effectively swallow the rule.

Implementation in the EEA looks set to be much easier, since member states are already subject to a single insurance regulatory regime. The expected departure of the UK may disrupt this to some extent, but we would not expect it to be difficult for the UK and the U.S. to reach a similar agreement to the Covered Agreement, assuming no significant change in political direction in either country. Moreover, the swift confirmation by BaFin that it will suspend local presence requirements for U.S. reinsurers, even before any formal equivalence decision is made by the European Commission, is a sign that the Covered Agreement is being welcomed in the EEA – though BaFin's qualification that it would reverse its position on local presence requirements if the Covered Agreement does not come into or remain in force should not be overlooked.

ENDNOTES

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[1] *Joint Statement on U.S.-EU Negotiations for a Bilateral Agreement on Insurance and Reinsurance Measures* (Jan. 2017), *available at* http://ec.europa.eu/finance/insurance/docs/solvency/international/170113-us-eu-joint-statement_en.pdf.

[2] Official Journal C 326/01, October 26, 2012, p. 1, *available at* http://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=OJ:C:2012:326:FULL&from=EN.

[3] Directive 2009/138/EC, Official Journal L 335, at 1 (Dec. 17, 2009), *available at* http://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=OJ:L:2009:335:FULL&from=EN.

[4] *Bilateral Agreement between the European Union and the United States of America on Prudential Measures Regarding Insurance and Reinsurance* (hereinafter, "Agreement") art. 10(2)(b), (f), *available at* http://ec.europa.eu/finance/insurance/docs/solvency/international/170113-us-eu-agreement_en.pdf.

[5] AIA, Press Release: *AIA Hails Covered Agreement; Will Benefit Insurers on Both Sides of the Atlantic* (Jan. 13, 2017), *available at* http://www.aiadc.org/media-center/all-news-releases/2017/january/aia-hails-covered-agreement-will-benefit-insurers-on-both-sides-of-the-atlantic.

[6] NAIC, Press Release: *NAIC Responds to Treasury/EU Deal* (Jan. 13, 2017), *available at* http://naic.org/Releases/2017_docs/naic_responds_to_treasury_eu_deal.htm.

[7] EIOPA, Press Release: *EIOPA Welcomes the EU-U.S. Covered Agreement on Insurance and Reinsurance Measures* (Jan. 13, 2017), *available at* https://eiopa.europa.eu/Publications/Press%20Releases/2017-01-13%20EU-US%20Agreement.pdf.

[8] Federal Insurance Office, U.S. Department of the Treasury, *The Breadth and Scope of the Global Reinsurance Market and the Critical Role Such Market Plays in Supporting Insurance in the United States*, at 24-25 (Dec. 2014), *available at* https://www.treasury.gov/initiatives/fio/reports-and-notices/Documents/FIO%20-%20Reinsurance%20Report.pdf.

[9] NAIC, *Credit for Reinsurance Model Law (#785)*, *available at* http://www.naic.org/store/free/MDL-785.pdf .

[10] NAIC, *Credit for Reinsurance Model Regulation (#786)*, *available at* http://www.naic.org/store/free/MDL-786.pdf.

[11] NAIC, *SMI Dashboard*, *available at* http://www.naic.org/documents/committees_e_related_smi_dashboard.pdf.

[12] NAIC Financial Regulation Standards and Accreditation (F) Committee, *Recent Changes to Accreditation Standards*, *available at* http://www-beta.naic.org/committees_f.htm (accessed Jan. 18, 2017).

[13] State departments of insurance in all 50 states, the District of Columbia, and Puerto Rico currently hold NAIC financial regulation accreditation. *See* NAIC & The Center for Insurance Policy and Research, *Accreditation* (last updated Jan. 6, 2017), *available at* http://www.naic.org/cipr_topics/topic_accreditation.htm.

[14] NAIC, *Credit for Reinsurance Model Law (#785)* § 2(E)(3).

[15] NAIC, *List of Qualified Jurisdictions* (as of Jan. 1, 2015), *available at* http://www.naic.org/documents/committees_e_reinsurance_qualified_jurisdictions_list.pdf.

[16] NAIC, *Credit for Reinsurance Model Law (#785)* § 2(E)(6).

[17] *Id.*§ 2(E)(1).

[18] NAIC, *Certified Reinsurers*, *available at* http://www.naic.org/cmte_e_reinsurance_certified_reinsurers.htm (accessed Jan. 18, 2017).

[19] 31 U.S.C. § 313(c)(1)(A).

[20] *Id.* § 313(c)(1)(E).

[21] Federal Insurance Office, U.S. Department of the Treasury, *How to Modernize and Improve the System of Insurance Regulation in the United States*, at 38 (Dec. 2013).

[22] *Id.*

[23] The EEA is the "European Economic Area". It includes the EU countries plus Iceland, Lichtenstein and Norway. Under an agreement between the EU and these countries, these countries have agreed to accept the application of certain EU legislation as part of their laws, and this includes Solvency II. Accordingly, Solvency II draws a distinction between "EEA" and "non-EEA", rather than between "EU"

and "non-EU". The Covered Agreement refers only to the EU, and not to the EEA, so its application in Iceland, Lichtenstein and Norway remains in doubt.

[24] EIOPA, *Equivalence*, *available at* https://eiopa.europa.eu/external-relations/equivalence/

[25] Directive 2005/68/EC, Official Journal L 323, at 1 (Dec. 9, 2005), *available at* http://eur-lex.europa.eu/legal-content/EN/TXT/HTML/?uri=OJ:L:2005:323:FULL&from=EN#L_2005323EN.01000101.doc.

[26] BaFin, *Conduct of Reinsurance Business in Germany by Insurance Undertakings Situated in a Third Country* (Aug. 31, 2016), *available at* https://www.bafin.de/SharedDocs/Veroeffentlichungen/EN/Auslegungsentscheidung/VA/ae_160901_rueckversicherung_drittstaaten_va_en.html.

[27] *Id.*

[28] 31 U.S.C. § 313(r)(2).

[29] *Id.* § 313(r)(9).

[30] Letters from Anne Wall, Assistant Secretary for Legislative Affairs, Department of the Treasury and Mike Harney, Assistant U.S. Trade Representative for Congressional Affairs, Office of the U.S. Trade Representative, to The Honorable Richard Shelby, Chairman, Committee on Banking, Housing, and Urban Affairs, U.S. Senate; The Honorable Sherrod Brown, Ranking Member, Committee on Banking, Housing and Urban Affairs, U.S. Senate; The Honorable Orrin Hatch, Chairman, Committee on Finance, U.S. Senate; The Honorable Ron Wyden, Ranking Member, Committee on Finance, U.S. Senate; The Honorable Jeb Hensarling, Chairman, Committee on Financial Services, U.S. House of Representatives; The Honorable Maxine Waters, Ranking Member, Committee on Financial Services, U.S. House of Representatives; The Honorable Kevin Brady, Chairman, Committee on Ways and Means, U.S. House of Representatives; and The Honorable Sander Levin, Ranking Member, Committee on Ways and Means, U.S. House of Representatives (Nov. 20, 2015), *available at* https://www.treasury.gov/initiatives/fio/reports-and-notices/Documents/Covered%20Agreement%20Letters%20to%20Congress.pdf.

[31] *See, e.g.,* Testimony of Julie Mix McPeak, Commissioner, Tennessee Department of Commerce and Insurance, on Behalf of the National Association of Insurance Commissioners, Before the Subcommittee on Housing and Insurance, Committee on Financial Services, U.S. House of Representatives, Regarding: The Impact of U.S.-EU Dialogues on U.S. Insurance Markets (Sept. 28, 2016), *available at* http://www.naic.org/documents/testimony_160928_mcpeak.pdf.

[32] *Joint Statement on U.S.-EU Negotiations for a Bilateral Agreement on Insurance and Reinsurance Measures* (Jan. 2017), *available at* http://ec.europa.eu/finance/insurance/docs/solvency/international/170113-us-eu-joint-statement_en.pdf.

[33] Agreement art. 3.

[34] 31 U.S.C. § 313(f)(1).

[35] *Id.* § 313(f)(2)(A).

[36] *Id.* § 313(f)(2)(C).

[37] *Id.* § 313(f)(3).

[38] *Id.*

[39] *Id.* § 313(f)(2)(B).

[40] *Id.* § 313(g).

[41] U.S. Department of the Treasury, Press Release: *Treasury, USTR Successfully Complete Negotiations for a Covered Agreement with the European Union* (Jan. 13, 2017), *available at* https://www.treasury.gov/press-center/press-releases/Pages/jl0705.aspx.

[42] Agreement art. 3.

[43] *Id.*

[44] *Id.*

[45] *Id.*

[46] *Id.* art. 10(2)(g).

[47] U.S. Department of the Treasury, *Fact Sheet: Bilateral Agreement between the European Union and the United States of America on Prudential Measures Regarding Insurance and Reinsurance* (Jan. 18, 2017), *available at* https://www.treasury.gov/initiatives/fio/reports-and-notices/Documents/Covered-Agreement-Fact-Sheet-(011317)-FINAL.PDF.

[48] Agreement art. 9.

[49] *Id.*
[50] NAIC, Press Release: *NAIC Responds to Treasury/EU Deal* (Jan. 13, 2017), *available at* http://naic.org/Releases/2017_docs/naic_responds_to_treasury_eu_deal.htm.
[51] Agreement art. 3(8).
[52] Agreement art. 4(a). In this context, "worldwide" means "all operations or activities of a group, wherever they occur." *Id.* art. 2(s).
[53] Agreement art. 4(b). The Agreement defines "undertaking" as "any entity engaged in economic activity." *Id.* art. 2(q).
[54] "Host supervisory authority" means a supervisory authority from the territory "in which the (re)insurance group or undertaking has operations, but is not the territory in which the worldwide parent undertaking of the (re)insurance group or undertaking has its head office or is domiciled." *Id.* art. 2(h), (i).
[55] Agreement art. 4(c).
[56] *Id.*
[57] *Id.* art. 4(d).
[58] *Id.* art. 4(e).
[59] *Id.* art. 4(f), (g).
[60] *Id.* art. 4 (g).
[61] *Id.* art. 4(h)(i).
[62] *Id.* art. 4(h)(ii).
[63] *Id.* art. 4(i).
[64] Directive 2002/87/EC of the European Parliament and of the Council of 16 December 2002 on the supplementary supervision of credit institutions, insurance undertakings and investment firms in a financial conglomerate and amending Council Directives 73/239/EEC, 79/267/EEC, 92/49/EEC, 92/96/EEC, 93/6/EEC and 93/22/EEC, and Directives 98/78/EC and 2000/12/EC of the European Parliament and of the Council, *available at* http://eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX:32002L0087.
[65] Agreement art. 10(2)(a).
[66] *Id.*
[67] *Id.* art. 10(e).
[68] NAIC, *Insurance Holding Company System Regulatory Act (#440)*, *available at* http://www.naic.org/store/free/MDL-440.pdf.
[69] *See, e.g.,* NAIC Group Capital Calculation (E) Working Group, *Meeting Summary Report* (Dec. 10, 2016), *available at* http://www.naic.org/meetings1612/cmte_e_grp_capital_wg_2016_fall_nm_summary.pdf?1485205267599
[70] Agreement art. 5.
[71] *Id.* art. 3(4)(a).