

**U.S. Treasury Department and the U. S. Trade Representative Pursuing  
Possible Covered Agreement With the European Union**

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The Dodd-Frank Act, for the first time, provided the United States government with the limited authority to regulate the business of insurance and reinsurance through the entry into what is termed “Covered Agreements” with foreign countries or regulatory entities which preempt the authority of the states to regulate certain aspects of the business of insurance and reinsurance. Such authority represents a modification of the framework for the regulation of the business of insurance and reinsurance in the United States, which with limited exceptions has been the sole province of the states since the enactment of the McCarran-Ferguson Act<sup>1</sup> in 1945. The circumstances under which this federal regulatory authority might be utilized has been the topic of discussion among insurance regulators, insurance professionals and at the National Association of Insurance Commissioners (“NAIC”). The exercise of this authority is circumscribed by the Dodd-Frank Act both in terms of how such authority may be exercised and the circumstances under which a Covered Agreement may pre-empt the state regulation of the business of insurance.<sup>2</sup>

On November 20, 2015 the Treasury Department and the U. S. Trade Representative provided written notice to Congressional Committees (the “Notification Letters”) of their intention to initiate negotiations with the European Union (“EU”) to enter into a Covered

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<sup>1</sup> 15 U.S.C. §§ 1011-1015.

<sup>2</sup> See 31 U.S.C. §313(f).

Agreement, representing the first exercise of this new statutory authority.<sup>3</sup> According to the Notification Letters, the Director will seek a Covered Agreement covering two topics: (1) the “equivalence” of the United States’ insurance and reinsurance regulatory scheme for purposes of the EU’s Solvency II initiative; and (2) collateral requirements for credit for reinsurance. This article explores the background and potential implications of this notification.

## **I. The Pertinent Statutory Framework**

The authority of the Federal Insurance Office (“FIO”) is set out in 31 U.S.C. §313(c)(1) and includes:

(E) to coordinate Federal efforts and develop Federal policy on prudential aspects of international insurance matters, including representing the United States, as appropriate, in the International Association of Insurance Supervisors (or a successor entity) and assisting the Secretary in negotiating covered agreements (as such term is defined in subsection (r)); [and]

(F) to determine, in accordance with subsection (f), whether State insurance measures are preempted by covered agreements....

The term Covered Agreement is defined as follows:

(2) Covered agreement. The term “covered agreement” means 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

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<sup>3</sup> The Notification Letters may be found at <https://www.treasury.gov/initiatives/fio/reports-and-notices/Documents/Covered%20Agreement%20Letters%20to%20Congress.pdf>.

Such notification is required by the Dodd-Frank Act as the first step in the Covered Agreement process. The Director of the Federal Insurance Office (“the Director”) is responsible conducting the Covered Agreement process. *See e.g.* 31 U.S.C. §313(f).

substantially equivalent to the level of protection achieved under State insurance or reinsurance regulation.

31 U.S.C. §313(r)(2). The term “State insurance measure” is defined broadly to include “any State law, regulation, administrative ruling, bulletin, guideline, or practice relating to or affecting prudential measures applicable to insurance or reinsurance.” 31 U.S.C. §313(r)(7).

The determination of whether State Insurance Measures are pre-empted by a Covered Agreement is made by the Director. 31 U.S.C. §313(f) provides the process through which such a determination must be made. A State Insurance Measure may be pre-empted by a Covered Agreement only if such state measure:

- (A) results in less favorable treatment of a non-United States insurer domiciled in a foreign jurisdiction that is subject to a covered agreement than a United States insurer domiciled, licensed, or otherwise admitted in that State; and
- (B) is inconsistent with a covered agreement.

31 U.S.C. §313(f)(1).

Before making such a determination the Director must: (1) notify and consult with the appropriate State regarding any potential inconsistency or preemption; (2) notify and consult with the United States Trade Representative regarding any potential inconsistency or preemption; (3) cause to be published in the Federal Register notice of the issue regarding the potential inconsistency or preemption, including a description of each State insurance measure at issue and any applicable covered agreement; (4) provide interested parties a reasonable opportunity to submit written comments to the Office; and (5) consider any comments received.

31 U.S.C. §313(f)(2)(A).

The NAIC has zealously guarded the exclusive right of the states to regulate the business of insurance. The authority to enter into Covered Agreements is a narrow exception to the state

regulatory structure for the business of insurance. The Dodd-Frank Act includes the following provision:

(k) Retention of Existing State Regulatory Authority.—Nothing in this section or section 314 shall be construed to establish or provide the Office or the Department of the Treasury with general supervisory or regulatory authority over the business of insurance.

31 U.S.C. §313(k).

## **II. The Initial Covered Agreement Process Starts**

The Notification Letters describe the prudential measures as to which a Covered Agreement is being sought.

[C]overed agreement negotiations with the EU will seek to address the following prudential measures: (1) obtain treatment of the U.S. insurance regulatory system by the EU as “equivalent” to allow for a level playing field for U.S. insurers and reinsurers operating in the EU; (2) obtain recognition by the EU of the integrated state and federal insurance regulatory and oversight system in the United States, including with respect to group supervision; (3) facilitate the exchange of confidential regulatory information between lead supervisors across national borders; (4) afford nationally uniform treatment of EU-based reinsurers operating in the United States, including with respect to collateral requirements; and (5) obtain permanent equivalent treatment for the solvency regime in the United States and applicable to insurance and reinsurance undertakings.

### **A. Possible Covered Agreement Topic: The Equivalency of the U.S. Regulatory Structure**

Following the global economic stress which began in 2008 both the EU and the NAIC began the process of adopting financial regulatory reform which included the insurance and reinsurance sectors. In the EU the current manifestation of this process is known as Solvency II.<sup>4</sup>

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<sup>4</sup> For basic information concerning Solvency II see <https://eiopa.europa.eu/regulation-supervision/insurance/solvency-ii>.

In the U.S., the NAIC's parallel initiative is known as the Solvency Modernization Initiative.<sup>5</sup> Both of these regulatory initiatives involve multiple areas such as capital requirements, financial reporting and disclosure, corporate governance and market conduct regulation.

The EU's Solvency II initiative contains certain requirements for the participation of non-EU domiciled insurers and reinsurers in the EU market.<sup>6</sup> Full and open participation by non-EU domiciled insurance and reinsurance companies in the EU market is predicated in part upon a finding that the regulatory regime of their domiciliary jurisdiction is "equivalent" to that of the EU. Solvency II sets forth a process for the EU assessing and designating other jurisdictions as "equivalent" for purposes of Solvency II. The EU has issued preliminary findings concerning the equivalence of certain jurisdictions, but it appears highly likely that the U.S. will not obtain an equivalency designation by the time that the requirements of Solvency II are implemented. Given the size and inter-relatedness of the U.S. and EU insurance and reinsurance markets it is considered important that EU and U.S. domiciled insurers and reinsurers be able to participate in both the U.S. and EU markets on an equitable basis.

The Notification Letters note the role of the Solvency II equivalence requirement in prompting the desire for a Covered Agreement.

Effective January 1, 2016, the EU will implement insurance regulatory reform (known as "Solvency II") that will subject an insurer to disadvantageous treatment if the insurer's country of domicile is not recognized by the EU as "equivalent" under the provisions of Solvency II. Through negotiating a covered agreement, Treasury and USTR will seek to ensure that U.S. insurers and reinsurers will be permitted to operate in the EU on the same regulatory terms as

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<sup>5</sup> For basic information concerning SMI see [http://www.naic.org/index\\_smi.htm](http://www.naic.org/index_smi.htm).

<sup>6</sup> These requirements are complex, and their substance is beyond the scope of this article.

insurers and reinsurers domiciled in the EU or in jurisdictions deemed equivalent under Solvency II.<sup>7</sup>

The FIO discussed the importance of the global reinsurance market in its initial report on the U.S. and global reinsurance market, *The Breadth and Scope of the Global Reinsurance Market and the Critical Role Such Market Plays in Supporting Insurance in the United States* (December 31, 2014) (“Global Reinsurance Market Report”),<sup>8</sup> and as recently as its 2015 Annual Report (issued in September 2015).<sup>9</sup> While it did not single out the Solvency II equivalency issue for mention in either of those two reports, it is likely that the inclusion of this topic in a possible Covered Agreement is in large part the result of the lack of progress in the U.S. obtaining a Solvency II equivalence determination through the Solvency II process, and the potential implications for both the EU and the U.S. insurance and reinsurance sectors of the absence of an equivalency finding by the EU at the time that Solvency II is implemented. Whether the assessment of the U.S. market in the Solvency II equivalence process will continue on a parallel track, or the anticipated Covered Agreement will substitute for that determination as a permanent functional equivalent of an equivalence determination, is unclear.

There are other structures already in place which provide for information sharing which might support the operation of a Covered Agreement relating to equivalency. For example, the EU-U.S. Insurance Project encourages its constituents to join the International Association of

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<sup>7</sup> Notification Letters page 2.

<sup>8</sup> See <https://www.treasury.gov/initiatives/fio/reports-and-notice/Document/FIO%20-%20Reinsurance%20Report.pdf> at 26-42.

<sup>9</sup> [https://www.treasury.gov/initiatives/fio/reports-and-notice/Document/2015%20FIO%20Annual%20Report\\_Final.pdf](https://www.treasury.gov/initiatives/fio/reports-and-notice/Document/2015%20FIO%20Annual%20Report_Final.pdf) at 76-81.

Insurance Supervisors Multilateral Memorandum of Understanding and existing bilateral Memoranda of Understanding (“MOU”) on exchanges of information between U.S. states and federal agencies and EU member states.<sup>10</sup> In addition, there are a significant number of bilateral MOUs already in place. On August 15, 2015 the NAIC announced the signing of an MOU with Bermuda focused on information sharing.<sup>11</sup> The press release announcing that agreement noted that the NAIC had entered into MOUs with 15 individual and regional jurisdictions representing 34 countries. The NAIC has provided the states a model MOU for use with the Centers for Medicare & Medicaid Services,<sup>12</sup> which is part of the United States Department of Health and Human Services that is active in health care insurance issues.<sup>13</sup> However, it is questionable whether it would be possible to achieve what would amount to Solvency II equivalency determination through an MOU process.

**B. Possible Covered Agreement Topic: Credit for Reinsurance and Collateral Requirements**

The inclusion of this topic in the Notification Letters is not a surprise, because the FIO has suggested several times, in its short history, that it might seek a Covered Agreement concerning the collateral requirements imposed by U.S. states for ceding insurers to receive full financial statement credit for reinsurance provided by non-accredited, non-U.S. domiciled

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<sup>10</sup> See [http://www.naic.org/documents/committees\\_g\\_exposures\\_euus\\_dialogue\\_project\\_proposal\\_1407\\_update.pdf](http://www.naic.org/documents/committees_g_exposures_euus_dialogue_project_proposal_1407_update.pdf).

<sup>11</sup> See [http://www.naic.org/Releases/2015\\_docs/naic\\_signs\\_mou\\_with\\_bermuda.htm](http://www.naic.org/Releases/2015_docs/naic_signs_mou_with_bermuda.htm).

<sup>12</sup> See [http://www.naic.org/documents/committees\\_b\\_senior\\_issues\\_FINAL\\_MOU\\_061129.pdf](http://www.naic.org/documents/committees_b_senior_issues_FINAL_MOU_061129.pdf).

<sup>13</sup> See <https://www.cms.gov/About-CMS/About-CMS.html>.

reinsurers. A high level overview of this issue may illustrate the reasons for the suggestion of a Covered Agreement with respect to this issue.<sup>14</sup>

Historically, states generally have required that non-U.S. domiciled reinsurers provide cedents collateral for 100% of reinsured risks. Non-U.S. domiciled reinsurers have contended over many years that this collateral requirement is discriminatory and inappropriate, and places non-U.S. domiciled reinsurers at a competitive disadvantage, increasing the cost of reinsurance for many U.S. insurers without a corresponding benefit. Non-U.S. companies and regulators have long advocated that the reinsurance of risks in the U.S. be subject to a sliding scale of required collateral levels linked to the financial strength of the reinsurer, with lower collateral levels being required of financially stronger reinsurers.

The NAIC adopted a Model Act and Model Regulation (“the Model”) in this area in 1984.<sup>15</sup> Prior to amendments to the Model adopted by the NAIC in November 2011<sup>16</sup> the Model required that reinsurance provided by non-U.S. reinsurers be secured by collateral representing 100% of U.S. liabilities for which the credit is recorded, and most, if not all, states had adopted credit for reinsurance requirements which included such a requirement. The NAIC’s

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<sup>14</sup> There is a substantial history to the issue of the circumstances under which a ceding insurer can take full financial statement credit for reinsurance and the role of collateral in that process, which has been the subject of many posts on our blog ([www.ReinsuranceFocus.com](http://www.ReinsuranceFocus.com)). A full description of that history is beyond the scope of this article.

<sup>15</sup> A history of the Model may be found in a GAO report which is available at <http://www.naic.org/store/free/MDL-785.pdf> (see page 27).

<sup>16</sup> See <http://www.naic.org/store/free/MDL-785.pdf>.



Reinsurance Task Force was considering reduced collateral requirements as early as August 2001, but it took over 10 years for such a provision to be added to the Model.

Meanwhile, the reinsurance collateral issue was being discussed in other forums. In an effort to provide a comprehensive framework for the regulation of reinsurance by the states, the NAIC adopted the Reinsurance Regulatory Modernization Framework Proposal at its Winter 2008 National Meeting, which included a provision which would reduce the collateral requirements for reinsurers meeting certain requirements for financial strength and business practices that are domiciled in jurisdictions that have been approved based on the effectiveness of their reinsurance supervision. Given the inability of the NAIC or the states to impose this broad regulatory structure nationally the NAIC proposed to implement it through a federal law, termed the Reinsurance Regulatory Modernization Act of 2009 (RRMA), but this effort failed when the NAIC could not find a member of Congress to sponsor this proposed federal legislation in Congress.

The Dodd-Frank Act, adopted by Congress in 2010, included a chapter termed the Non-Admitted and Reinsurance Reform Act (“NRRA”), which changed the landscape of this issue somewhat by adopting a prohibition of a state denying credit for reinsurance to a ceding insurer if the domiciliary state of the ceding insurer recognizes such credit and was a NAIC-accredited state. The NRRA therefore preempts the extraterritorial application of state credit for reinsurance law, and would permit states to proceed forward with reinsurance collateral reforms on an individual basis if they are accredited.

Meanwhile, a few states had started reinsurance collateral reform efforts on their own. In 2006, after two particularly difficult hurricane seasons which threw the insurance and

reinsurance markets into disarray in the State of Florida, Florida became the first state to adopt a statutory structure that permitted its insurers to take full financial statement credit for reinsurance provided by reinsurers domiciled outside the U.S. without the requirement for 100% collateral for such obligations for reinsurance of certain property/casualty risks, providing a sliding scale of required collateral based largely upon the perceived financial strength of the non-U.S. reinsurer.<sup>17</sup> New York followed in 2010, adopting a similar structure applicable to reinsurance of both property/casualty and life risks.<sup>18</sup> A few other states followed, adopting a similar structure.

Faced with several states with a substantial presence in the reinsurance market taking unilateral action, the NAIC finally adopted amendments to the Model which adopted the concept of linking the level of collateral to the financial strength of the reinsurer, largely along the lines of the Florida and New York regulatory models.<sup>19</sup> Like all Models, however, this Model is effective in a state only to the extent that the state adopts the Model by legislative enactment. The adoption of the revised Model by the states has been slow and uneven, with some states modifying the language of the Model.<sup>20</sup>

The reinsurance market in the U.S. is not state based, and many reinsurance agreements cover risks arising out of activities in more than one state, giving rise to a desire among many in the industry for a uniform nationwide rule for reinsurance collateral. The slow pace of adoption

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<sup>17</sup> See Fla. Stat. §624.610(3)(e).

<sup>18</sup> See [http://www.dfs.ny.gov/insurance/r\\_finala/2010/rf17\\_20t.pdf](http://www.dfs.ny.gov/insurance/r_finala/2010/rf17_20t.pdf).

<sup>19</sup> See <http://www.naic.org/store/free/MDL-785.pdf>.

<sup>20</sup> See <http://www.naic.org/store/free/MDL-785.pdf>.

of the Model, and the lack of complete uniformity of the terms of the Model adopted in the adopting states, has frustrated the advocates of a uniform collateral rule for the entire U.S. reinsurance market and contributed to the FIO's criticism of this process. Perhaps in part in response to such criticism, the NAIC has discussed the possibility of making the reinsurance collateral requirements in the Model part of the accreditation process for U.S. insurers and reinsurers, which would make the standards uniform nationwide, yet there has not been substantial progress in making such requirements part of the accreditation standards.<sup>21</sup>

The FIO's reports have repeatedly discussed the need for nationwide uniformity with respect to the credit for reinsurance/collateral issue. The FIO described some of the history of the credit for reinsurance collateral requirements and the lack of uniformity with respect to this issue in its Global Reinsurance Market Report.<sup>22</sup> The 2015 FIO Annual Report is critical of what it termed the slow progress of credit for reinsurance reform and mentioned that one of the "agreed-upon initiatives" of the EU-U.S. Insurance Project was to pursue a Covered Agreement for reinsurance collateral requirements based upon the Model.<sup>23</sup>

Not surprisingly, the NAIC opposes the need for covered agreements generally as an unwarranted intrusion upon the regulation of the business of insurance by the states, and with

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<sup>21</sup> See [http://www.naic.org/committees\\_f.htm](http://www.naic.org/committees_f.htm) (showing the only reinsurance-related issue active in the accreditation committee relates to a much more recent controversy concerning the use of captives). The NAIC also has a process of designating non-U.S. jurisdictions as "Qualified Jurisdictions" for certain purposes. See [http://www.naic.org/committees\\_e\\_reinsurance.htm](http://www.naic.org/committees_e_reinsurance.htm) and [http://www.naic.org/documents/committees\\_e\\_reinsurance\\_qualified\\_jurisdictions\\_list.pdf](http://www.naic.org/documents/committees_e_reinsurance_qualified_jurisdictions_list.pdf).

<sup>22</sup> See <https://www.treasury.gov/initiatives/fio/reports-and-notices/Documents/FIO%20-%20Reinsurance%20Report.pdf> at 23-25.

<sup>23</sup> [https://www.treasury.gov/initiatives/fio/reports-and-notices/Documents/2015%20FIO%20Annual%20Report\\_Final.pdf](https://www.treasury.gov/initiatives/fio/reports-and-notices/Documents/2015%20FIO%20Annual%20Report_Final.pdf) at 11 and 80-81.

respect to the reinsurance collateral issue in particular. “In light of the progress made by the NAIC and the states to modernize credit for reinsurance rules, the NAIC is neither convinced nor persuaded that a covered agreement for reinsurance collateral is necessary.”<sup>24</sup>

Clearly, there is disagreement as to the sufficiency of the response by the states and the NAIC with respect to this issue, and the FIO has taken the next step from its statement of intention in its 2014 Report and its 2015 Annual Report to initiate the Covered Agreement process with respect to the reinsurance collateral issue.

### **III. What Might The Future Hold?**

The progress of negotiations for a Covered Agreement on the equivalence question is likely to be of widespread interest throughout the insurance and reinsurance sectors in both the U.S. and the EU given the importance of the EU and the U.S. markets in the global insurance and reinsurance sectors. While the reinsurance collateral issue has been a thorny issue for EU domiciled companies for a much longer time, that issue would seem to have a smaller interested constituency. While neither the EU nor the U.S. side has mentioned any possible timetable for the discussions concerning a possible Covered Agreement, the implementation of Solvency II on January 1, 2016 is right around the corner.

The NAIC has so far been quiet concerning the Notification Letters. The Notification Letters were sent during the recent NAIC fall meeting, and hence was not a topic at that meeting. While the NAIC has publicly taken the position that a Covered Agreement concerning credit for reinsurance issues is not necessary, it may have a much more difficult time opposing the attempt

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<sup>24</sup> [http://www.naic.org/cipr\\_topics/topic\\_covered\\_agreement.htm](http://www.naic.org/cipr_topics/topic_covered_agreement.htm). See also [http://www.naic.org/documents/government\\_relations\\_issue\\_brief\\_covered\\_agreement\\_reins\\_collateral.pdf](http://www.naic.org/documents/government_relations_issue_brief_covered_agreement_reins_collateral.pdf).

to achieve at least provisional equivalence for Solvency II purposes through a Covered Agreement.

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