The U.S.-EU Covered Agreement: Different Assessments By Different Audiences

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On January 13, 2017, the week before the inauguration of President Trump, the U.S. Department of Treasury and the Office of the U.S. Trade Representative announced that the negotiations between the United States and the European Union for a covered agreement had been completed, and that the full text of the agreement ("the Covered Agreement" or "the Agreement") had been forwarded to Congress as required by 31 U.S.C. § 313(c)(1).[1] Treasury has provided a "fact sheet" describing the Covered Agreement,[2] as well as the full text of the Covered Agreement and the transmission letters to the appropriate Congressional committees.[3]

Also on January 13, 2017, the United States and the European Union released a joint statement announcing the successful negotiations.[4] The statement noted that the Covered Agreement "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." Any consumer protection benefits of the Covered Agreement would, at best, only be indirect, through the potential for more effective supervisory regulation of large, multi-national insurance and reinsurance groups. The primary benefits of the Covered Agreement appear to be enhanced business competitiveness for U.S. and EU domiciled reinsurers in the U.S. and EU markets.

The process of negotiating the Agreement began, as required by the Dodd-Frank Act, when the Treasury and the United States Trade Representative provided notice to Congress in November 2015[5] of their intention to enter into negotiations with the EU for a covered agreement encompassing the following topics:

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1 *See* https://www.treasury.gov/press-center/press-releases/Pages/jl0705.aspx.

2 *See* https://www.treasury.gov/initiatives/fio/reports-and-notices/Documents/Covered-Agreement-Fact-Sheet-(011317)-FINAL.PDF.

3 *See* https://www.treasury.gov/initiatives/fio/Documents/Final%20Covered%20Agreement%20Letters%20to%20Congress%20Full%20Text.pdf.

4 *See* https://ustr.gov/about-us/policy-offices/press-office/press-releases/2017/january/joint-statement-us-eu-negotiations.

5 *See* https://www.treasury.gov/initiatives/fio/reports-and-notices/Documents/Covered%20Agreement%20Letters%20to%20Congress.pdf.

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, with respect to the EU's Solvency II regulatory regime;

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.

This article discusses the Covered Agreement and whether the agreement recently presented to Congress is likely to accomplish the goals set forth in the November 2015 notification to Congress.

I. Covered Agreements Generally

The Dodd-Frank Act ("the Act") introduced the concept of covered agreements into the area of insurance and reinsurance by providing that "The Secretary and the United States Trade Representative are authorized, jointly, to negotiate and enter into covered agreements on behalf of the United States."[6] The Act defines covered agreement 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—
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> (A) is entered into between the United States and one or more foreign governments, authorities, or regulatory entities; and
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> (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.[7]

[6] 31 U.S.C. § 314.

[7] 31 U.S.C. § 313(r).

Covered agreements are not treaties, and are not subject confirmation by the Senate. The full text of any covered agreement must be submitted to certain Congressional committees,[8] and such agreements do not go into effect until the expiration of a period of 90 calendar days beginning on the date on which the copy of the final legal text of the agreement is submitted to the Congressional committees.[9] A covered agreement may pre-empt state law if the Director of the Federal Insurance Office determines that pre-emptive effect is appropriate under a statutorily prescribed determination procedure and standards.[10] In this context, covered agreements are a means for limited federal intrusion into the regulation of the business of insurance and reinsurance by the states, and principally are designed to achieve uniformity throughout the United States with respect to a particular issue or issues.

II. The US-EU Covered Agreement

The Covered Agreement contains provisions in three substantive areas: (1) requirements for reinsurance collateral for financial statement credit for reinsurance; (2) group regulatory supervision; and (3) the exchange of insurance information between supervisors. The provisions of the Covered Agreement are summarized below. The Covered Agreement generally accomplishes the goals set forth in the November 2015 letters to Congress, with the possible exception of the Solvency II-related equivalence determinations.

A. Reinsurance Credit and Collateral

There has been a well-documented dispute over many years over the requirement of state laws that non-U.S. domiciled reinsurers must post collateral for reinsurance of risks of U.S. domiciled cedents in order for the ceding insurers to obtain full financial statement credit for such reinsurance. In 2007 Florida became the first state to adopt a regulation providing for the posting of reduced collateral levels based in large part upon the financial strength rating of the reinsurer. New York adopted a similar reduced collateral regulation in 2010.

The National Association of Insurance Commissioners, which had been exploring including provisions relating to credit for reinsurance in the Credit for Reinsurance Model Law[11] ("the Model Law") since the mid-1980s, added collateral reduction provisions to the Model Law in 2011.[12] Model Laws are only recommendations by the NAIC, and do not have any legal

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8 31 U.S.C. § 313(c)(1).

9 31 U.S.C. § 313(c)(2).

10 31 U.S.C. § 313(f).

11 Model Law 785 (*see* http://www.naic.org/store/free/MDL-785.pdf).

12 The Nonadmitted and Reinsurance Reform Act, part of the Dodd-Frank Act, which became effective in July 2010, pre-empted the extraterritorial application of state credit for reinsurance laws.

effect in a state unless it, or a variant, is adopted by the state legislature. The adoption of this Model Law by the states was relatively slow. Not all states have adopted the Model Act as law, and some states have adopted amendments to the Model Law. This slowness and continuing lack of nationwide uniformity have supported continued foreign criticism with respect to this issue as it affects the participation of EU companies in the U.S. market. The Federal Insurance Office identified this issue early in its existence as being of concern due to the lack of uniformity in how the states addressed the issue, and a potential topic for a covered agreement.[13]

The Covered Agreement eliminates local presence and collateral requirements for U.S. domiciled reinsurers operating in the EU market and for EU domiciled reinsurers operating in the U.S. market, which requirements have been imposed by U.S. states as a condition for the ceding company obtaining regulatory credit for the reinsurance. Unlike the U.S. Model Law, there is no sliding scale of collateral required based upon the financial strength of the reinsurer. Rather, the requirement for the provision of any collateral for the assumption of risk through reinsurance is eliminated entirely, provided that the reinsurer complies with six requirements.

This relief from a legal requirement for collateral is not provided to reinsurers without cost or condition. To obtain this collateral and local presence relief a reinsurer is required: (1) to maintain a stated minimum level of capital or surplus of $250 million; (2) maintain, on an ongoing basis, a solvency ratio of 100% SCR under Solvency II or an RBC of 300% Authorized Control Level; (3) consent to jurisdiction in the ceding jurisdiction and the appointment of the supervisory authority of the ceding jurisdiction as an agent to accept service of process; (4) agree to pay any judgment obtained by the ceding insurer and provide 100% security for any final judgment liability it resists; (5) pay reinsurance claims promptly; and (6) confirm that it is not participating in a solvent scheme of arrangement and provide 100% collateral for the terms of any subsequent scheme of arrangement.

The Covered Agreement eliminates only the ability of a jurisdiction to impose a legal requirement for the posting of collateral as a condition for the ceding insurer obtaining full financial statement credit for reinsurance. It expressly does not prevent a ceding insurer and a reinsurer from agreeing, by contract, that the reinsurer will provide any type or level of collateral as a part of a reinsurance contract between them. Whether such a contractual agreement is likely in the current reinsurance market is another question.

There is a lengthy implementation period for these provisions, in part because of the state-based regulation of the business of insurance in the U.S. U.S. states are encouraged to adapt their credit for reinsurance requirements to the Covered Agreement. The Director of the Federal Office of Insurance then makes a determination, under the terms of the Dodd-Frank Act, whether any state laws should be pre-empted by the Covered Agreement. That determination is

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[13] *See e.g.* the September 2015 "Annual Report on the Insurance Industry" of the Federal Insurance Office at pages 11 and 81. This Report may be found at https://www.treasury.gov/initiatives/fio/reports-and-notices/Documents/2015%20FIO%20Annual%20Report_Final.pdf.

not scheduled to be made earlier than 60 months after the execution of the Covered Agreement.

B. Regulatory Supervision

There has been concern, uncertainty and some conflict over the most efficient and effective way to supervise large insurance and reinsurance companies, or groups of companies, that operate in multiple countries. Controversy has been greater with respect to issues as to which different jurisdictions apply different and at times contradictory supervisory standards, especially when a jurisdiction may seek effectively to apply its own standards on an extraterritorial basis to the conduct of a company in another jurisdiction. For example, some members of Congress have voiced concern that the EU seeks to impose capital and other supervisory rules on insurance or reinsurance companies domiciled in the United States because they do business in the EU. This concern may be complicated by the fact that large insurance and reinsurance companies may have some subsidiaries domiciled in the EU, some domiciled in the U.S., and others domiciled in yet other jurisdictions. This general issue is discussed in more detail in Section II.D. below.

The Covered Agreement seeks to resolve this regulatory supervision dispute by providing generally that the predominant supervision, including group governance, solvency, capital and a worldwide group Own Risk and Solvency Assessment, should be exercised by the jurisdiction in which the overall headquarters of the corporate group is domiciled and located.

For example, pursuant to the Covered Agreement:

- The group supervision practices described in the Covered Agreement apply only to U.S. and EU insurance groups operating in both the U.S. and the EU. They do not apply to insurance groups which operate entirely in only the U.S. or the EU.

- U.S. insurance groups operating in the EU will be supervised at the worldwide group level only by the relevant U.S. insurance supervisors, i.e., the state insurance department for the state in which the highest level company is domiciled. EU insurers operating in the United States will be supervised at the worldwide group level only by the relevant EU insurance supervisors.

- U.S. insurance groups operating in the EU will not have to meet EU worldwide group capital, reporting, or governance requirements.

- With respect to risks from outside their territories that threaten operations and activities within their territories, supervisors in both the United States and the EU can request information from insurance groups from the other party, and take appropriate action within their territory to protect policyholders and financial stability.

The Covered Agreement does not entirely cede to the other jurisdiction the responsibility for consumer protection. Under the Covered Agreement, supervisory authorities on both sides

reserve the ability to request and obtain information about worldwide activities which could harm policyholders' interests or financial stability in their territory, specifically "where such information is deemed necessary ... 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 ...."[14]

Furthermore, if a summary of the worldwide group Own Risk and Solvency Assessment ("ORSHA") or its equivalent "exposes any serious threat to policyholder protection or financial stability in the territory of the ... [jurisdiction not exercising primary supervisory responsibility, that jurisdiction] may impose preventive, corrective, or otherwise responsive measures with respect to insurers or reinsurers in ... [its own territory]."[15] Although this portion of the Covered Agreement is intended to be responsive in part to Congressional concerns that the protection of U.S. consumers, companies and markets not be handed over to EU insurance supervisors, in the U.S., the ORSA Report is only required to be filed in the insurer's domiciliary jurisdiction. It is unclear how another non-domiciliary jurisdiction would learn of the potential threats in a timely manner, except perhaps through the sharing of information between supervisors/regulators.

Finally, the Covered Agreement contains provisions which appear intended to provide that provisions of certain laws of the U.S. and the EU regulating the financial services sector, including the U.S.'s Dodd-Frank Act and the EU's Solvency II regime, would take precedence over the Covered Agreement should they conflict.[16]

C. Information Exchange Between Supervisors

The Covered Agreement also encourages insurance supervisory authorities in the United States and the EU to continue to exchange supervisory information with respect to insurers and reinsurers that operate in both the U.S. and EU markets. To help guide the implementation of Article 5, model memorandum of understanding provisions for consideration by supervisory authorities are included in an Annex to the Covered Agreement.

The goal of this exchange is to "enhance cooperation and information sharing."[17] Information is to be exchanged "while respecting a high standard of confidentiality protection."[18] To avoid issues arising from different privacy and confidentiality laws in the EU and the U.S. relating to personal information, the Covered Agreement provides that "[n]othing in this Agreement addresses requirements that may apply to the exchange of personal data by

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14 Covered Agreement, Article 4, section (g).

15 Covered Agreement, Article 4, section (e).

16 Covered Agreement, Article 4, section (i).

17 Covered Agreement, Article 5, section 1.

18 *Id.*

supervisory authorities."[19] One of the provisions of the Annex reads that "[i]t generally is not considered a legitimate regulatory or supervisory purpose for a Requesting Authority to seek information on individuals, unless the request is directly relevant to the fulfilment of supervisory functions."[20] These provisions appear to be intended to preserve the authority of the signatories (and the U.S. states) to regulate the privacy and confidentiality of the personal information of individuals as they see fit.

D. Solvency II Equivalence

The EU's Solvency II regime provides standards for minimum capital, solvency regulation, corporate governance, risk assessment and management and public reporting. EU insurance supervisors assert the right to apply some of these standards to the worldwide operations of foreign insurers and reinsurers who do business in the EU, unless there is a determination that the regulatory structure and supervision of the foreign companies is "equivalent" to the EU's regulatory structure and requirements. An equivalence determination may be made with respect to three areas: (1) reinsurance contracts; (2) solvency assessment; and (3) group supervision. A determination of "full equivalence" requires a determination of equivalence with respect to all three of these areas. To date, the U.S. has been found to be equivalent, on a temporary or provisional basis, only with respect to the solvency assessment factor. The EU has adopted a complicated set of statutes and regulations which govern equivalence determinations.

The full implementation of Solvency II without a finding that the U.S. market is "equivalent" to the EU market would significantly disadvantage the operation of U.S. domiciled insurers and reinsurers in the EU market. This potential has been of great concern for U.S. insurance and reinsurance companies and regulators. The Federal Insurance Office early on its existence identified this as an important topic to be addressed in a possible covered agreement.

The Covered Agreement does not contain an express determination or finding that the U.S. is "equivalent" for purposes of Solvency II with respect to any of these three areas, and does not contain an express provision changing the EU's preliminary determination of equivalence with respect to the solvency topic into a permanent equivalence determination with respect to that factor of Solvency II. The reinsurance presence and collateral and group supervision provisions of the Covered Agreement, however, seem clearly to be intended to accomplish the policy goals of a Solvency II equivalence determination with respect to those topics.

It is not within the scope of this article to discuss whether the Covered Agreement's provisions in those areas may be a substitute for a Solvency II equivalence determination under EU law, or whether a functional equivalent of a Solvency II equivalence determination is appropriate under EU law. It may be that there will be a subsequent document issued by the EU making an equivalency determination under Solvency II based, in part, on the anticipated

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19 Covered Agreement, Article 5, section 2.

20 Covered Agreement Annex, Article 4, section 1.

implementation of the Covered Agreement and the previous provisional equivalency determination with respect to the solvency assessment topic. On the other hand, the Covered Agreement provisions with respect to reinsurance contracts and how supervisory authority will be exercised with respect to worldwide insurance and reinsurance companies may be considered by the EU to be sufficient equivalency "determinations" or an acceptable substitute for formal equivalence determinations with respect to those areas.

E. The Covered Agreement and the Trump Administration

Since the Covered Agreement was negotiated by the Obama administration and announced one week before the inauguration of President Trump, and given the disagreement of the Trump administration with many of the financial services policies of the Obama administration, one might ask whether the Trump administration will support the Covered Agreement, seek to modify its terms or delay its implementation. As of the writing of this article the Trump administration has not commented on the Agreement. However, the House Financial Services Committee's Subcommittee on Housing and Insurance held a hearing to "assess" the Agreement on February 16, 2017.

Four witnesses testified at the hearing: Ted Nickel, Wisconsin Insurance Commissioner; Charles Chamness, President and Chief Executive Officer, National Association of Mutual Insurance Companies; Leigh Ann Pusey, President and Chief Executive Officer, American Insurance Association; and Michael McRaith, former Director of the Federal Insurance Office and a chief negotiator of the Agreement.[21]

The witnesses expressed starkly divergent views of the Agreement. With respect to the treatment of the U.S. state-based insurance regulatory regime, one described the Agreement as a historic recognition by the EU of the U.S. stated-based insurance regulatory regime, while another called it an attempt by the EU to impose its group capital requirements on U.S. insurance regulators and domiciled companies, contrary to the capital regime of U.S. states. With respect to the collateral for reinsurance provisions, one praised the NAIC's progress towards a Model Act in this area and described the Agreement as imposing a serious reduction of collateral from 100% of the reinsurance obligations to 0%, while another described the NAIC's efforts at a Model Act as a failure and the Agreement's collateral reduction provision accomplishing a much more modest reduction from already reduced collateral levels of 10-20% to 0%. With respect to the stated goal of obtaining a declaration of equivalence for the U.S. regulatory regime under Solvency II, one witness described the Agreement a complete failure as it does not even mention equivalence, while another praised it as preventing the upstreaming of the EU's Solvency II corporate governance and capital requirements to the U.S. domiciled parents of U.S. domiciled companies operating in the EU.

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[21] The written submissions of the witnesses may be found on the Committee's internet site at http://financialservices.house.gov/calendar/eventsingle.aspx?EventID=401498. A video of the hearing is available on You Tube at https://www.youtube.com/watch?v=LnQEenIOYnA.

The Covered Agreement automatically comes into force, with respect to U.S. law, after a 90 day layover period, without a vote of Congress. Although Congress may not modify the agreement, either the U.S. or the EU may terminate the agreement on appropriate notice. Although the witnesses expressed widely divergent views of the value of the agreement for the U.S., none of them disputed that if the agreement were to be terminated by the U.S., U.S. domiciled companies operating in the EU would have rather severe restrictions and requirements imposed upon them by the EU.

CONCLUSION

With the possible exception of achieving Solvency II equivalence, over which there is some dispute, the Covered Agreement seems to accomplish the goals set forth in the November 2015 notification to Congress. There remains disagreement as to whether there is a need to address the reinsurance collateral issue in a covered agreement as opposed to a Model Act. If the Covered Agreement is implemented according to its terms and with the appropriate pre-emption over conflicting state laws, the long-standing conflict over the need for foreign reinsurers to provide collateral for risks ceded to them by U.S.-domiciled insurers finally may be resolved.

The supervisory and information sharing provisions also are fairly clear. However, it is not completely clear that the Covered Agreement resolves the problem of the United States not being granted full equivalence status under Solvency II. While the Covered Agreement may provide the United States a functional equivalent of Solvency II equivalence, it remains to be seen whether that is true.

Whether the Trump administration will permit the Agreement to be implemented will be seen. If it decides to terminate the Agreement, U.S. domiciled companies doing business in the EU likely would be the ones having to deal with the resulting fallout.

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 This article appeared on the firm's reinsurance and arbitration blog, www.ReinsuranceFocus.com.

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