The US and EU finalize a Covered Agreement on insurance and reinsurance regulation

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On January 13, 2017, the US Treasury reported to Congress that Treasury and the US Trade Representative (USTR) had successfully concluded negotiations with the EU on a Covered Agreement (the Agreement) that would presumably open the markets for US and EU insurers and reinsurers, and potentially preempt state laws on collateral for reinsurance. In this alert, we explore what happened, what happens next (and when) and what this could mean for insurers and reinsurers in the US and EU.

What is a "covered agreement"?

Historically, state insurance laws have required non-US reinsurers to deposit collateral in the US sufficient to fully secure future liabilities to US insurers, and for many years the EU and other countries have strongly objected to these laws as trade barriers. Perceiving a lack of progress by the states to modify their reinsurance collateral laws to ease these burdens on non-US reinsurers, Congress, in Title V of the Dodd-Frank Act, authorized representatives from Treasury and the USTR to jointly conclude a bilateral or multi-lateral agreement with other countries or international regulatory bodies on "prudential insurance measures," including an agreement on uniform reinsurance collateral requirements. However, the Act also provides that any regulatory measure subject to a covered agreement would have to achieve a level of protection for US consumers that is "substantially equivalent" to the level of protection achieved currently under state law. The covered agreement also could not address or be used to preempt state law on such matters as rates, premiums, underwriting and sales practices, as well as state insurance coverage requirements.

What does the recently concluded Agreement do?

The Agreement announced last Friday covers three areas of "prudential insurance" oversight: (i) reinsurance; (ii) group supervision; and (iii) the exchange of insurance information between supervisors.

With regard to reinsurance, the Agreement makes clear that a signatory to the Agreement— which, through preemption rules, would extend to each state—cannot impose on a non-US assuming reinsurer collateral requirements that it does not also impose on a US assuming reinsurer. Thus, if reinsurers domiciled in the state of Connecticut (referred to as the "host party") are not required to post collateral when assuming risk from Connecticut-based ceding insurers, then the Connecticut insurance regulator cannot require a reinsurer domiciled in Germany (referred to as the "home party) to post collateral when assuming a risk from a Connecticut insurer. The same would be true for any "local presence" requirements imposed by a host party. Thus, Germany (in this case, the host party) cannot require a Connecticut reinsurer to maintain a local presence or office in Germany in order to assume risk from a German insurer if Germany does not also impose that requirement on reinsurers domiciled in Germany.

To qualify for these special reinsurance measures under the Agreement, an assuming reinsurer must, among other things: (i) have capital and surplus in excess of US$250 million or EU€226 million; (ii) have an RBC ratio of 300% authorized control level or a solvency ratio of 100% SCR under Solvency II; (iii) maintain a practice of prompt payment of reinsured claims; and (iv) agree to service of process in the host party and to pay all final judgments obtained by a ceding insurer in the courts of the host party.

As for group supervision, the Agreement seeks to clarify that US and EU insurers operating in a jurisdiction that is a party to the Agreement will be subject to worldwide prudential insurance group oversight only by the supervisors in their home jurisdiction. Outside of the home jurisdiction, the limitations on the home party's exercise of worldwide group oversight include matters involving solvency and capital, reporting and governance. Supervisors nevertheless preserve the ability to request and obtain information about worldwide activities that could harm policyholders' interests or financial stability in their territory.

With respect to the exchange of information, the Agreement encourages (but does not require) insurance supervisory authorities in the US and EU to continue to exchange supervisory information on insurers and reinsurers that operate in their markets. To support such information exchange, the Agreement includes model memorandum of understanding provisions.

When does the Agreement take effect?

In the US, Title V of Dodd-Frank requires that a covered agreement can only take effect if Treasury and the USTR jointly submit it to the House Financial Services, House Ways and Means, Senate Banking and Senate Finance Committees on a day the House and Senate are in session, and then wait for a period of 90 days. Submission of the Agreement to Congress on January 13 was intended to comply with these requirements and start the 90-day clock.

The EU, for its part, will follow the necessary steps, involving the European Council and the European Parliament and pursuant to the Treaty on the Functioning of the European Union, to sign and formally conclude the Agreement. The EU might try to expedite the process by obtaining authority for the Council to sign on behalf of EU members.

Can the new Congress prevent the Agreement from taking effect?

Yes. Congress retains the authority to enact legislation that could block the Agreement from taking effect. However, based on the initial reactions from insurer and reinsurer trade groups, it appears unlikely that there will be pressure on Congress to address the Agreement. One possible source of such pressure, however, could be US ceding insurers that have no interest in acting as a reinsurer in the EU, and therefore do not benefit from the Agreement. Such companies might object that the Agreement does not achieve "substantially equivalent" consumer protections as exist under current state law insofar as it could eliminate collateral requirements that are currently in place for the protection of consumers.

Can the Agreement preempt state law?

Yes. The Agreement requires the US to encourage every state to promptly adopt measures (i) seeking, in each year following the effective date of the Agreement, a 20 percent reduction of the collateral the state would have otherwise required, and (ii) implementing relevant state credit for reinsurance laws and regulations consistent with the terms of the Agreement. No later than 42 months following execution of the Agreement, the US will thereafter be required to begin evaluating potential preemption determinations under its laws and regulations with respect to any state insurance measure that the US determines is inconsistent with the Agreement and results in less favorable treatment of an EU insurer or reinsurer than a US insurer or reinsurer domiciled, licensed or otherwise admitted in that state. That preemption review will be prioritized to consider those states with the highest volume of gross ceded reinsurance, and must be completed within 60 months following execution of the Agreement. If it is determined that a state law is preempted by the Agreement, then Treasury is required, among other things, to notify and consult with the affected state insurance regulator, publish the proposed preemption for public comment, and thereafter establish a reasonable time for the preemption to become effective. A state has the right to challenge that preemption determination in court.

How will the Agreement affect the US-EU dialogue with respect to the EU's determination of equivalency under the Solvency II regulatory framework?

Solvency II provides for the EU to make an equivalence determination for non-EU countries in the areas of group supervision, group solvency and reinsurance. Insofar as the Agreement now arguably establishes equivalent treatment of EU insurers and reinsurers in those areas, it could create additional pressure for the EU to grant the US with unqualified equivalency status. In fact, the European Commission has already deemed the US system of group solvency and confidentiality "provisionally" equivalent before the Agreement was in place. Alternatively, if industry is satisfied with the status quo that is ultimately reached under the Agreement, US regulators could altogether abandon equivalency negotiations as no longer being necessary.

As the counter-signatory to the Agreement is the EU, it is likely that, if and when the UK exits the EU, the UK and the US will want to put in place a bilateral agreement on similar terms. Indeed, such an agreement could form part of a wider trade deal between the UK and the US, but as such deals are complicated and take time to negotiate (despite President-elect Trump's stated desire to agree to a deal quickly), a stand-alone agreement may be required.

What is the NAIC's position on the Agreement?

On Friday, January 13, the NAIC issued the following statement, which suggests that it is dubious, to say the least, that the Agreement will meet Congress's mandate that any agreement must ensure that US consumers remain protected and that US companies will not be competitively disadvantaged relative to foreign insurers:

"After more than a year of secret meetings it’s disappointing that in the waning days of the administration we are finally seeing the details of what purports to be a covered agreement between the U.S. and EU," said Ted Nickel, NAIC President and Wisconsin Insurance Commissioner. "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 we encourage Congress to do the same. Of great concern is the potential to use this agreement as a backdoor to force foreign regulations on U.S. companies."

What could this mean for insurers and reinsurers

in the US and EU?

Insofar as EU reinsurers do far more business in the US than US reinsurers do in the EU, it appears that EU reinsurers stand to be the big winners under the Agreement. In addition, ceding insurers, particularly in the US, could benefit from even more competitive pricing in an already soft market. In theory, consumers could in turn benefit from the lower pricing and savings achieved by reducing collateral requirements. As a practical matter, however, it is likely that business as usual will continue with little noticeable change in the markets as a result of the Agreement. The Agreement could, however, create additional pressure on granting the US unqualified Solvency II equivalency since the US will at least arguably now have in place equivalent protections across all of the relevant Solvency II criteria.