Client Update
U.S. and EU Announce Insurance and Reinsurance Covered Agreement

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On January 13, 2017, the Secretary of the Treasury, the U.S. Trade Representative and the European Commission announced in a joint statement that the United States and the European Union (the "EU") had completed negotiations for an agreement on three areas of prudential insurance supervision: reinsurance, group supervision and information exchange (the "Covered Agreement").[1]

The completion of the negotiations of the Covered Agreement is a significant step in U.S.-EU relations following the implementation of Solvency II in the EU, which introduced new rules affecting insurers and reinsurers domiciled in non-European Economic Area ("EEA") countries that are not deemed to have an "equivalent" insurance regulatory regime. The terms of the Covered Agreement underscore the significance of the supervision of an entire insurance group to international regulators, which is not the standard insurance supervision system in the United States.

U.S. and EU representatives began formal negotiations of the Covered Agreement in February 2016, following more than 20 years of discussions between the sides on reinsurance collateral. Under U.S. law, the Covered Agreement may come into effect 90 days after it was submitted to the appropriate U.S. Congress committees, which submission occurred on January 13, 2017. In addition, the Covered Agreement will need to be approved by both the European Council and the European Parliament.

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[1] Press Release, U.S. Dep't of the Treasury, Treasury, USTR Successfully Complete Negotiations for a Covered Agreement with the European Union (Jan. 13, 2017), https://www.treasury.gov/press-center/press-releases/Pages/jl0705.aspx; The text of the Covered Agreement and the letters to Congress are available at https://www.treasury.gov/initiatives/fio/Documents/Final%20Covered%20Agreement%20Letters%20to%20Congress%20Full%20Text.pdf.

It is important to note that the Covered Agreement does not extend "equivalence" status to the U.S. under Solvency II, which would have substantially facilitated cross-border reinsurance transactions between the U.S. and the EU, and minimized regulatory overlap over worldwide groups. However, it does seek to reduce some of the regulatory frictions between the U.S. and European regulatory regimes, such as the requirement imposed by some European jurisdictions that U.S. reinsurers establish a physical presence in the relevant jurisdiction to reinsure business from such jurisdiction, and in so doing is an important step forward for groups operating in both regions.

We provide a summary of the key aspects of the Covered Agreement below.

BACKGROUND

The Federal Insurance Office Act of 2014 authorizes the Secretary of the Treasury and the United States Trade Representative to jointly negotiate a "written bilateral or multilateral agreement regarding prudential measures with respect to the business of insurance or reinsurance" with one or more foreign governments, authorities or regulatory entities.[2] In Europe, the European Commission negotiates international trading agreements with trading partners on behalf of the EU as a whole, but does so in close cooperation with the European Council and the European Parliament, who ultimately approve such trading agreements.

Until 2012 non-U.S. reinsurers were subject to 100% collateral requirements when reinsuring U.S. risks. Recently, the National Association of Insurance Commissioners ("NAIC"), the U.S. standard setting and regulatory support organization, passed amendments to its Credit for Reinsurance Model Law (#785) and Regulation (#796) that would reduce the amount of collateral certified reinsurers are required to post for U.S. claims, but not all states have adopted the models.[3] Certain EEA countries similarly require non-EEA reinsurers to post collateral and/or establish a local presence in the country in order to reinsure risks situated in that country. The collateral and local presence requirements were not specifically addressed in Solvency II, the regulatory regime for

[2] 31 U.S.C. § 314 (2016).

[3] As of December 11, 2016, the NAIC Reinsurance Task Force reported that 35 states have passed legislation to implement the amended Credit for Reinsurance Model Law with 28 of such states also adopting the amended Credit for Reinsurance Model Regulation. Insurers domiciled in these states represent approximately 69% of direct insurance premium written in the U.S. across all lines of business.

European insurers and reinsurers that came into effect on January 1, 2016, except for those countries that are deemed "equivalent" for reinsurance purposes.

REINSURANCE

The general theme with respect to the reinsurance provisions in the Covered Agreement is the intent that a foreign reinsurer not be disadvantaged relative to a locally domiciled reinsurer. Therefore, a substantial portion of the Covered Agreement addresses limitations on a non-domiciliary jurisdiction's (referred to as the "Host Party" in the Covered Agreement) authority to require foreign reinsurers to post collateral or have a local presence in the country in which such reinsurer is assuming risks if such restrictions would result in less favorable treatment of foreign reinsurers. However, there are significant capital requirements that a foreign reinsurer must meet before it is eligible for such equal treatment, including:

"Minimum Own Funds" if Reinsurer Transacting with EU-Domiciled Ceding Insurer	€226 million
Minimum Capital and Surplus if Reinsurer Transacting with U.S.-Domiciled Ceding Insurer	$250 million
Minimum Solvency Ratio / RBC	100% Solvency Capital Requirement under Solvency II / 300% Authorized Control Level

The same Minimum Own Funds and Minimum Solvency Ratio/RBC requirements apply where the reinsurer is an association including incorporated and individual unincorporated underwriters (e.g., a Lloyd's insurance syndicate).

In addition, to qualify for the exemptions, among other things, the foreign reinsurer must:

- consent to the jurisdiction of the Host Party's courts;
- consent to pay all final judgments obtained by a ceding insurer;
- agree to post collateral for 100% of the assuming reinsurer's liabilities attributable to reinsurance ceded if the assuming reinsurer resists enforcement of a final judgment;

- provide certain financial information, such as annual audited financial statements, solvency reports, lists of reinsurance claims disputed or outstanding for at least 90 days, to the Host Party supervisory authority; and
- demonstrate a practice of prompt payment of reinsurance claims.

With respect to some requirements, the foreign reinsurer must provide written confirmation of its compliance to the Host Party supervisor. For other requirements, such as the agreement to post collateral if it resists enforcement of a final judgment, the foreign reinsurer must add such a provision to any reinsurance agreement subject to the Covered Agreement. The requirements apply only to prospective reinsurance contracts entered into, amended or renewed.

GROUP SUPERVISION

Solvency II provides that insurers and reinsurers established in non-EEA countries whose insurance regime is deemed "equivalent" to Solvency II may operate in Europe without additional regulatory burdens. Equivalence essentially places non-EEA insurers and reinsurers on a level playing field with EEA insurers and reinsurers for prudential regulation purposes. However, so far only Bermuda and Switzerland have been granted full equivalence. The U.S. currently has only been granted provisional equivalence with regard to group solvency calculations, which allows EEA groups with U.S. insurance and reinsurance subsidiaries to reflect the subsidiaries' RBC calculation in their group capital requirements, subject to certain conditions. However, U.S. insurers and reinsurers with EEA subsidiaries or branches are still potentially subject to group supervision in the EU, although in practice EU regulators usually "ring fence" a European Solvency II group, avoiding worldwide group supervision.

The preamble of the Covered Agreement notes the importance of group supervision in enabling "supervisory authorities to form sound judgments of the financial position of" insurance groups.[4] In a nod to the international emphasis on a group capital measure, the preamble also acknowledges "the need for a group capital requirement or assessment for insurers and reinsurers forming part of a group that operates" in the U.S. and the EU and affirms "the importance of specifications for the group capital requirement or assessment for group supervision and of, where warranted, the application of corrective . . . measures by a supervisory authority based on that requirement . . ."[5] Accordingly, the

[4] Covered Agreement at 1.

[5] *Id.* at 2.

Covered Agreement ostensibly acknowledges that an insurer or reinsurer operating in both the U.S. and the EU should be subject only to "worldwide prudential insurance group supervision, including governance, solvency and capital and reporting, as applicable, by its Home supervisory authorities…."[6] However, the Host Party supervisor retains authority to "impose preventative, corrective or otherwise responsive measures" with respect to a foreign insurer or reinsurer operating in the Host Party if such company's Own Risk and Solvency Assessment ("ORSA") "exposes any serious threat to policyholder protection or financial stability" in the Host Party's territory.[7]

The Covered Agreement's group capital discussion will likely put pressure on U.S. regulators to adopt a group capital calculation and to increase regulatory ability to impose responsive measures on a group. The Covered Agreement states that a Host Party supervisor should not impose a group capital assessment or requirement on the level of the worldwide parent conducting business in its territory as long as the Home Party regulator (i) requires a group capital assessment, including a worldwide group capital calculation capturing group risk and (ii) has the supervisory authority to "impose preventative, corrective, or otherwise responsive measures on the basis of the assessment, including requiring, where appropriate, capital measures."[8]

INFORMATION EXCHANGE

The Covered Agreement also sets forth a model Memorandum of Understanding related to information sharing between regulatory authorities in different jurisdictions. The model details the form in which information requests should be made, provides for such information to be treated confidentially and prohibits such information from being further shared by the recipient unless the recipient receives consent from the provider or there is a similar confidentiality agreement in place with third-party recipient.

REACTION AND NEXT STEPS

The NAIC greeted the announcement of the Covered Agreement with wariness, promising to review the Covered Agreement "to ensure consumers remain protected and U.S. companies are not competitively disadvantaged relative to

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6 *Id*. at 10.

7 *Id*. at 11.

8 *Id*.

foreign insurers."[9] The NAIC also noted the lack of transparency in the creation of the Covered Agreement, noting: "Of great concern is the potential to use this agreement as a backdoor to force foreign regulations on U.S. companies."[10]

The Covered Agreement was broadly welcomed by the London insurance market, which is a major reinsurer of U.S. risk. The International Underwriting Association said that the deal would lead to a more level playing field between EU and U.S. reinsurers and greatly enhance international reinsurance regulation. The European Insurance and Occupational Pensions Authority ("EIOPA") said that the agreement would strengthen supervisory co-operation and enhance regulatory certainty.

The Covered Agreement takes effect on the later of the date of the entry into force or in January 2022. In the meantime, the Covered Agreement requires the United States and EU to encourage regulators to refrain from implementing measures that are inconsistent with the conditions or obligations of the Covered Agreement. In addition, the United States is to encourage each U.S. state to promptly adopt a reduction in collateral required to allow full credit for reinsurance with such reduction to equal 20% of the collateral that such state required of EU reinsurers as of January 1, 2017 and to implement relevant credit for reinsurance laws consistent with the Covered Agreement's reinsurance provisions. Moreover, within 42 months after the Covered Agreement becomes effective, the United States must begin evaluating a potential preemption determination with respect to any state insurance laws and regulations that the United States determines are inconsistent with the Covered Agreement.

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Please do not hesitate to contact us with any questions.

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[9] Press Release, National Association of Insurance Commissioners, NAIC Responds to Treasury/EU Deal (Jan. 13, 2017), http://naic.org/Releases/2017_docs/naic_responds_to_treasury_eu_deal.htm.

[10] *Id.*