

## **NAMIC Analysis of the Bilateral Agreement Between the EU-U.S. on Prudential Measures Insurance and Reinsurance – 1-13-17 Covered Agreement**

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On January 13, 2017, the U.S. Treasury and the European Commission released to their respective legislative governing bodies the final text of the “covered agreement” negotiated, addressing U.S. reinsurance collateral requirements and U.S. insurance regulatory equivalence under Solvency II. Both jurisdictions have additional process to apply before the agreement is in force. In the U.S., there is a 90-day layover in the governing Senate and House committees. In the EU, the Parliament must approve the agreement. Then and only then will the agreement be fully executed.

This agreement was perceived by many U.S. companies engaged internationally in offering insurance or reinsurance as a necessary step to alleviate the uncertain mandates that could be issued to companies desiring to do business in the EU since Solvency II was implemented in 2016. The primary goal for most of these U.S. insurance companies was to settle – promptly and finally – the question of U.S. insurance regulatory equivalence with the basic premises of Solvency II in the EU. Permanent equivalence or mutual recognition was the initial charge for U.S. negotiators. For the Europeans, the goal was to lower the requirements for reinsurance collateral in the U.S. that applied to non-U.S. reinsurers doing business with U.S. ceding companies and address questions about confidentiality of information shared with the U.S. insurance regulators.

The three prudential areas addressed in the agreement are Reinsurance Collateral, Group Supervision, and Confidential Exchange of Information. In our analysis of the agreement we uncovered positive features, negative features, and many ambiguous areas requiring additional information. Our initial impression is that at the very least the agreement does not meet the U.S. goal, as it will not go into force for five years, it does not actually say that it replaces the need for the U.S. to be found an equivalent third country jurisdiction under Solvency II, and it is unclear whether some of the provisions in the agreement are in effect beyond the five-year period set forth in Article 10 – Application of the Agreement. This uncertainty and the development of an on-going Joint Committee to continue discussions and negotiations imply that this has created a never-ending process of negotiations between the parties regarding insurance group regulation.

To assist member understanding of the terms of the agreement this analysis notes the details of the agreement below and includes NAMIC’s impression and ranking of each matter.

Points of Analysis are ranked as:

**Advantage** – Clear value and advantage to the U.S. industry

**Advantage, But . . .** – There is value, but it is the way things should be

**Ambiguous** – Uncertain language intent, inconsistent use in the agreement, clear analysis not obvious

**Disadvantage** – Clear disadvantage to the U.S. industry

**Major Disadvantage** – Primary problem with the agreement

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January 13, 2017 Covered Agreement

**Reinsurance** – The provisions of this section are better than expected. While the agreement does eliminate collateral requirements for EU reinsurers, it includes a provision that may be intended to prohibit the NAIC and state regulators from pushing the lost reinsurance collateral to the ceding companies as an enhanced capital requirement. That would be positive for ceding companies if the NAIC abided by the language. The provisions also increase the requirements applicable to the EU reinsurers for ensuring payment of claims owed and enforcing judgments. [While all sections of this portion of the agreement (art. 3) are mutually applicable to the parties, we refer only to the implications from the standpoint of the U.S., since the EU does not apply collateral requirements to reinsurers.]

- **No Collateral – Disadvantage.** No EU reinsurer, meeting all other requirements to do business in the U.S., can be required to post collateral in the U.S. (art. 3(1)(a)). Of course, this could negatively impact insurers, both small and large, if they are unable to negotiate collateral in the terms of a reinsurance treaty. The lack of a collateral requirement may result in lower reinsurance premiums, but that was occurring anyway because of the current soft market. Another point of concern is that following the agreement release, Bermuda questioned whether it should also have zero collateral for its reinsurers in the U.S. This could be just the beginning of zero collateral for all.
- **No Requirements Like Collateral – Ambiguous.** The U.S. government agrees to ensure that no other state regulatory requirement will have the same regulatory impact on EU reinsurers as the former collateral requirement (art. 3(1)(b)). This provision may be intended to prohibit the NAIC and state regulators from pushing the lost reinsurance collateral to the ceding companies as an enhanced capital requirement. If such action can arguably be considered “less favourable treatment” of EU reinsurers, then there is a chance for a concession for the U.S. ceding company. We have concerns that this interpretation would not be adhered to by the NAIC, but that was reportedly the intention of the parties negotiating the agreement.
- **Enforcement of U.S. Judgments/Prompt Payment – Advantage.** EU reinsurers must consent to the jurisdiction of the U.S. courts, provide a U.S. agent for service of process, agree to pay all final judgments, and if they resist paying final judgments, they must post 100 percent collateral again. In addition, new requirements related to prompt payment are imposed on such reinsurers if they have more than 15 percent of reinsurance recoverables overdue and other protections (art. 3(4)). Some of these provisions are currently included in state law for non-U.S. reinsurers, but this agreement could strengthen enforcement.
- **Prohibition on Local Presence Requirement – Advantage and Ambiguous.** Under the agreement, the EU supervisors can no longer require U.S. groups doing business in EU member states to have a “local presence” in the country (art. 3(3)) unless they have a similar requirement for their domestic (re)insurers. This protection can be revoked if the agreement terminates for any reason. While U.S. reinsurers are considering this an important concession,

this is only an advantage for U.S. groups doing business in the EU if the EU supervisor does not currently have, or decide to add, a similar requirement for the domestic EU companies. In addition, it is important to note that if the agreement fails or terminates, it would be much easier to undo forbearance of a local presence demands in the EU than to repeal new state laws/regulations eliminating reinsurance collateral. This is not an equal trade for U.S. insurers.

- **EU Reinsurance “Schemes” – Advantage.** Regardless of the elimination of collateral for traditional reinsurers from the EU, reinsurance that includes a “scheme of arrangement” with a U.S. ceding party can be required by U.S. regulators to post 100 percent collateral (art. 3(4)(j)). These are risky endeavors in the EU that are not deserving of a zero-collateral designation. This is good news for U.S. ceding companies.
- **Treaties May Contain Collateral Requirements – Advantage, But . . .** Regardless of the elimination of regulatory collateral, ceding companies may enter into reinsurance contracts/treaties that include a contractual collateral requirement. Nothing in the covered agreement prevents such private agreements. While this language is good, it is the way it is now, and the way it should be (art.3(7)).
- **Not Retrospective – Advantage, But . . .** The obligations under covered agreement only apply to reinsurance agreements entered into after any changes to collateral requirements take effect. They are not retrospective. While this language is good, it is the way any change in the law or regulations should be applied (art. 3(8)).
- **EU-U.S. to “Encourage” Immediate Application of Terms – Advantage.** Supervisors in EU member states and U.S. states will be encouraged to start applying the intention of the covered agreement as soon as possible (art. 9). EU supervisors are to stop sending letters to the companies requiring compliance with Solvency II or local presence in the country (art 9(1)). U.S. states are to promptly adopt a 20 percent per year reduction in the amount of collateral required from EU reinsurers (art. 9 (3)(a)). These are just good faith provisions, as there is no authority to enforce and no enforcement mechanism for either of these actions.
- **Preemption of State Law – Major Disadvantage.** Under the agreement, the U.S. government commits to start evaluating whether preemption should apply to individual states 3-½ years after the agreement is signed (art. 9(4)). Imposition of preemption is required to start after 60 months if states have not complied. The government must start with preemption of the largest states based on ceded premium first. In the agreement, there is no similar preemption provision for any EU member state that refuses to comply, but there is language in the Solvency II Directive Art 175 related to reinsurance (see also Omnibus II, par. 65) that includes member state adherence to EU agreements with “third countries.” Nonetheless any preemption of state law poses a major problem for the continuation of the state regulation of insurance and is a dangerous precedent allowing a foreign government to impose its regulatory mandate on U.S. states without a single legislative action at the state or federal level. This poses a question of the balance of powers in the U.S.

**Group Supervision** – While several portions of this article 4 are ambiguous and unclear, even making charitable assumptions about the intentions of the parties, the net effect is primarily negative. The article’s stated purpose is to lay out the practices of group supervision. The U.S. is authorized to provide

group supervision for its own domestic international insurance groups at the ultimate controlling parent level, as long as the U.S. supervises all practices worldwide. The EU will accept the U.S. worldwide ORSA from U.S. companies, but the EU supervisor can step in and require more reporting anytime they perceive a “serious threat to policyholder protection or financial stability.” They require U.S. regulators to impose a group capital assessment, but it must be a requirement, not just a tool. At least it must be enforceable and actionable if the supervisor determines capital levels are not high enough. Each provision of this section gives a little something, and then limits the application or provides exceptions. The combination of the exceptions and the lack of any statement about how this agreement relates to equivalence is very concerning.

- **U.S. Group Supervision – Ambiguous.** With several exceptions, the U.S. is authorized to provide group supervision for its own domestic insurance groups that do business internationally (art. 4(a)), but the EU supervisors are allowed to apply their group supervision and capital requirements to the U.S. group’s European holding company as well as any affiliates under that European group anywhere in the world (art. 4(b)). Since this was the area in the agreement that was supposed to provide the U.S. with an advantage in exchange for giving up reinsurance collateral, we expected it would be more than just a return to pre-Solvency II status quo with exceptions. There is no finding that U.S. group supervision is adequate, mutual, or equivalent, just that the EU will allow it to occur.
- **Exceptions to EU Recognition of U.S. Group Supervision – Disadvantage.** The exceptions to this group supervision agreement include the qualifying statement at the beginning of the paragraph that indicates this grant of authority is “without prejudice to subparagraphs (c) to (h)” and the remaining two paragraphs in Article 4, (b) and (i) include specific exceptions to the agreement for European holding companies and insurance groups with banks or deemed as systemically important.
- **Scope of the Group – Disadvantage.** For companies that are part of a larger conglomerate of companies there are additional concerns about the scope of the group. While “worldwide prudential insurance group supervision” is not defined, the definition of “worldwide parent undertaking” is defined to be the “ultimate parent undertaking of the group.” The ultimate parent in both the EU and the U.S. is intended to refer to the entire group including all economic activity both inside and outside of insurance/financial services. For conglomerate organizations that hold some insurance and financial legal entities, this would include the entire scope of entities within the conglomerate whether related to the insurance/financial entities or not. This may not be a direct issue for most mutual companies, but for those U.S. groups with this structure the agreement will require the U.S. group capital calculation to apply to unrelated entities in the conglomerate (art. 4(h)(i)).
- **ORSA – Disadvantage and Ambiguous.** The EU will accept the U.S. ORSA from U.S. companies, but it must be on a worldwide group basis. It is not clear, but is possible, that this requirement applies at the level of the ultimate parent. This scope for ORSA is inconsistent with the NAIC model ORSA law, which allows companies to determine how they want to report about their enterprise risk management – on a group or legal entity basis – and which contains no requirements beyond the insurance/financial entities within the group. This was one of the key issues regarding U.S. ORSA that companies be allowed to manage their own risk in their own

way. It is unknown whether this segment of the agreement will require a change in the ORSA laws, applying to all international companies or even possibly to all companies subject to ORSA. Also, the agreement allows the EU supervisor to step in and require more ERM reporting from, or corrective/preventive measures of, a U.S. domiciled company anytime they perceive that a risk included in the U.S. ORSA is a serious threat to EU policyholder protection or financial stability. This provision is perhaps fair, but it is also subject to abuse.

- **EU Information Authority – Disadvantage and Ambiguous.** While the initial statements in this section on Group Supervision seem to recognize the U.S. regulators' authority for the group supervision of their own companies, this section (art. 4(g)) overrides that authority with vague caveats. This section allows the EU supervisors to ask for "information" for purposes of prudential group supervision that is "deemed necessary" by the EU supervisor to protect against serious harm to policyholders or financial stability. Does this mean they can apply Solvency II reporting requirements? Does it include group financial reporting under IFRS? Does it require reporting under IAIS provisions not adopted in the U.S.? These are all open questions that add to the ambiguity of the situation.
- **Group Capital Assessment – Disadvantage and Ambiguous.** In Article 4(h), the U.S. is required to impose a group capital assessment that sounds similar to the NAIC project to develop a group capital calculation, but the covered agreement anticipates a calculation that is more than a tool. It must apply to the complete "worldwide parent undertaking" (see **Scope of the Group**). It must include corrective/preventive measures, up to and including capital measures. It is concerning if the intention is that this include the power to require increases in capital, capital movement between affiliates, or other fungibility mandates. If the U.S. imposes such a requirement, then the EU agrees not to impose its own capital requirement to that U.S. insurance group at the worldwide parent level.
- **Non-application – Ambiguous.** In Article 4(i), it is indicated that the covered agreement language accepting U.S. group supervision and capital does not apply to insurers whose financial distress could cause instability for the Host economy. We assume this refers to SIFI or G-SII level insurers. This section also indicates the covered agreement does not restrict the authority of the EU or the U.S. to apply different requirements to insurance groups that are also depository institution holding companies. These companies can be regulated by additional authorities other than their domestic insurance supervisors. There is some ambiguity about whether this section was intended just to authorize the Federal Reserve and Banking Supervisors in the EU to apply their regulations or if it voids the agreement for these companies altogether. This is an ambiguity that needs to be addressed.
- **No Treatment of Solvency II Equivalence – Major Disadvantage.** The most prominent failing of this agreement is that the terms of it do not provide U.S. insurance regulation with a grant of permanent equivalence or a permanent waiver of the equivalence requirements for purposes of Solvency II. As stated above, that was the whole purpose of addressing issues other than reinsurance collateral, and without resolving the question of equivalence this agreement seems to fail its primary purpose. Presumably after the agreement "enters into force" the EU will start the process of determining if the U.S. has equivalence or will waive the requirements, but there

is nothing in the agreement that requires such action by the EU. In fact, there is no use of the word “equivalence” in the whole agreement. This is very troubling issue.

- **Implementation and Application of the Agreement Unclear – Ambiguous.** The EU agrees to “provisionally” abide by Article 4 until the date it “enters into force” and, thereafter, will ensure that the member state supervisors follow the practices agreed upon. There is ambiguity about the date the agreement “enters into force.” It could be read to “enter into force” only after: 1) all the U.S. collateral laws have been revised; 2) the U.S. group capital assessment is final and required; and 3) local presence demands have been withdrawn in the EU member states. Some provisions imply that the agreement “enters into force” once it complies with all procedures required to make it final in both countries. At that point both parties are to start encouraging “provisional application” of the agreement. But following our review, Article 4 provisional application means very little. It provides very few EU obligations – only obligations of the U.S. to meet the principles of group supervision set forth.
- **Preemption Application to Group Supervision – Ambiguous.** It is not clear that it was the intention of the parties to apply preemption to the group supervision provisions, but the language of the agreement (Article 9) is not limited to the reinsurance article of the agreement. The Dodd-Frank Act states that the Director may only apply preemption to a state law that:  
“(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 USCS §313(f)(1)(A) and (B))

Some interpretations provide that this language limits application to the reinsurance requirements. But there is concern that the EU may expect the groupwide supervision language in the 2014 NAIC Holding Company Model Act to be adopted in every state. The NAIC has not decided whether that language should be a full accreditation requirement as it would not apply to many states’ domiciled insurers. This adds another ambiguity to the covered agreement interpretation.

**Exchange of Information – Advantage.** The U.S. and the EU have conceptually different ways of dealing with company information submitted to regulatory authorities. In the U.S., information submitted to government agencies is generally available to the public under the Freedom of Information Act or similar law unless the information is deemed a trade secret, privileged communication, and/or specifically identified as confidential in the law or regulation requiring its submission to the government agency. In the EU, government agencies hold such information as private or confidential as a rule. This created some issues for the EU concerning exchanges of information between the U.S. and EU insurance regulators. The EU was concerned that their domiciliary companies’ information would not be protected in the U.S. The inclusion of this issue in the negotiations and the language in Article 5 was intended to resolve this issue.

The Exchange of Information obligation in Article 5 of the covered agreement is to encourage U.S. states and EU member states to enter into model memorandum of understanding agreements with each other. That process has been on-going for some time. Several states have already signed a similar

memorandum of understanding. The model memorandum of understanding (included in the Annex to the covered agreement) provides that all information shared between the U.S. and the EU will be confidential unless both parties agree otherwise. There is also a notice requirement if there are any freedom of information, subpoena, or discovery requests for the information from the U.S. supervisor.

### General Issues

- **Joint Committee – Disadvantage.** While the parties may benefit from having a formal committee to help address disputes among the parties, the joint committee creation (art. 7) and required meetings once or twice a year add to the perception that this is intended to be an on-going evaluative process with the EU and U.S. federal authorities telling state regulators whether they are doing their jobs well enough to meet federal and EU standards. This was never the intent of Congress when it created FIO. Certainly, no government official would suggest that the EU should have on-going oversight of the U.S. state insurance laws and regulations. This also provides the U.S. Treasury/FIO more authority over state regulation than was ever intended under the Dodd-Frank Act.
- **Term of the Agreement – Disadvantage and Ambiguous.** There is very little said in the agreement about what happens after five years or the “entry into force” of the agreement. A couple of provisions indicate that the EU obligations under the agreement end after 60 months (art 10(2)(e) and (f)). Other provisions imply actions beyond the 60 months (art. 10(2)(a)). At a minimum, the uncertainty seems to result in an on-going obligation for the U.S. state regulators to satisfy the European Commission with our regulatory practices, but less clarity of what is required of the EU after 60 months.
- **Unclear Whether a Signature is Required – Ambiguous.** In the agreement (art. 9(4)) there is reference to the date of signature. The document provided is not signed, but has been presented to Congress as the Final Legal Text of the agreement that was agreed to in writing by the EU and the U.S. In the EU, there remains a process before the agreement is officially signed, but the Dodd-Frank Act is silent on this point. For this reason, it is unknown whether there is finality now or whether the agreement still needs to be signed by the Secretary of the Treasury, the USTR Ambassador, or the President. This also creates many unknowns.

### Conclusion

The final text of the Covered Agreement appears to have more negative provisions than added value especially for those insurance companies that only write in the U.S. Even for companies writing internationally the ambiguity of the agreement raises a lot of questions about what will really result from the agreement. One of the reasons for major concern regarding the ambiguities is that the key U.S. negotiators who were in the room throughout the discussions over the last five years are no longer in office and will not be able to hold the EU members of the joint party to “the intent” of the parties’ discussion. For that reason, this agreement is likely to fail, whether it does so before it is ever final, entered into force, or provisional, or whether it does so because the U.S. is disenchanted with the application and the implementation of the agreement. There are many aspects of the agreement that either party could point to as outside of their ability to enforce and ambiguities that could result in

differences in understanding during the process. A new agreement should be negotiated that meets the needs of the insurance-buying public, the insurance industry, and state regulators. This is a bad deal!