January 16, 2017

# U.S. and European Regulators Conclude Covered Agreement Negotiations

## U.S. and European Regulators Conclude Negotiations for a Covered Agreement between the United States and the European Union on Insurance and Reinsurance Prudential Measures

### SUMMARY

On January 13, 2017, the U.S. Department of the Treasury and the Office of the U.S. Trade Representative ("USTR") announced the successful completion of negotiations for a bilateral "Covered Agreement" between the European Union ("EU") and the United States on prudential measures regarding insurance and reinsurance.[1] Under Title V of the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank"), the Secretary of the Treasury ("Treasury"), acting through the Federal Insurance Office ("FIO"), and the USTR are authorized to jointly negotiate covered agreements, defined under Dodd-Frank as written bilateral or multilateral agreements between the United States and one or more foreign governments, authorities or regulators regarding prudential measures with respect to insurance or reinsurance, on the condition that the prudential measures subject to a covered agreement achieve a level of protection for insurance or reinsurance consumers that is "substantially equivalent" to the level of protection achieved under U.S. state insurance laws.

#### Prudential measures

The Covered Agreement addresses three areas of prudential insurance and reinsurance supervision:

- ***Reinsurance:*** Subject to certain conditions, the Covered Agreement eliminates local presence and collateral requirements as a condition for entering into reinsurance agreements or obtaining credit for reinsurance for regulatory purposes. These requirements are to be eliminated for U.S. reinsurers operating in the EU market and for EU reinsurers operating in the U.S. market. The Covered Agreement establishes financial strength and market conduct conditions that EU and U.S. reinsurers must meet in order to be exempt from local presence or collateral requirements (e.g., maintaining minimum capital and solvency standards and a record of prompt claims payments to ceding insurers).

- ***Group supervision:*** Subject to the fulfillment of certain conditions, U.S. insurance groups operating in the EU will be subject to worldwide group-level insurance prudential supervision (including group governance, solvency, capital and reporting requirements) only by the relevant U.S. insurance regulators. Likewise, EU insurance groups operating in the United States will be supervised at the worldwide group level only by the relevant EU insurance supervisors. Under the EU's Solvency II Directive (2009/138/EEC) and related regulations ("Solvency II"), EU supervisors have the ability to apply solvency and capital requirements to the worldwide operations of any U.S. insurance group operating in the EU. The group supervision provisions of the Covered Agreement are intended to preclude EU insurance supervisors from applying Solvency II group-level solvency and capital standards to U.S. insurance groups (the EU operations of U.S. insurers will, however, continue to be subject to applicable Solvency II standards). U.S. and EU supervisors will, nevertheless, preserve the ability to request and obtain information about worldwide activities that could harm policyholders or financial stability in their respective territories.
- ***Exchange of information:*** The Covered Agreement encourages insurance supervisors in the United States and the EU to exchange supervisory information. An annex to the Covered Agreement includes model provisions for a memorandum of understanding on information exchange that insurance supervisors are encouraged to adopt.

## Implementation and application

Entry into force of the Covered Agreement is subject to each party completing its respective internal requirements and procedures. On January 13, 2017, Treasury and the USTR submitted the text of the Covered Agreement to the Committee on Financial Services and the Committee on Ways and Means of the House of Representatives, and the Committee on Banking, Housing, and Urban Affairs and the Committee on Finance of the Senate (the "Congressional Committees"). In accordance with Dodd-Frank, the Covered Agreement may enter into force for the United States following a period of 90 calendar days from the date the text of the agreement was submitted to the Congressional Committees. The EU will follow the necessary steps, involving the Council of the European Union and the European Parliament and pursuant to the Treaty on the Functioning of the European Union, required to sign and formally conclude the Covered Agreement.[2]

The Covered Agreement includes provisions to ensure adherence to its terms and a mechanism for the parties to consult one another as needed. The Covered Agreement also sets forth, on a provision-by-provision basis, specific timelines for implementation of the agreement and establishes cross-conditionality between provisions. For example, the United States would not be required to implement the elimination of reinsurance collateral requirements if the EU fails to comply with terms of the agreement relating to group supervision or the elimination of local presence requirements for U.S. reinsurers. Likewise, the EU would be able to reapply Solvency II to worldwide group-level prudential supervision of U.S. insurance groups if the United States does not complete the necessary reinsurance reforms within the five-year period required under the Covered Agreement. The implementation and application timelines include:

- ***Preemption and state insurance reform***: Dodd-Frank provides that a state insurance law or regulation may be preempted upon a determination by FIO, in accordance with notice and other procedural requirements set forth in Dodd-Frank, that the state insurance measure is inconsistent with a covered agreement and results in less favorable treatment of non-U.S. insurers subject to the covered agreement than a U.S. insurer domiciled, licensed or otherwise admitted in the state. Under the Covered Agreement, U.S. states will have 60 months (five years) from signature of the agreement to adopt reinsurance reforms removing collateral requirements for EU reinsurers that meet the prescribed conditions in the Covered Agreement. FIO will begin the process of making potential preemption determinations of state laws that are inconsistent with the Covered Agreement after 42 months following signature of the agreement, with any preemption determination required to be completed by the end of the 60-month period. Accordingly, to the extent one or more U.S. states have failed to implement the necessary state-level reinsurance reforms by the end of the 60-month period, FIO will be required to have made a preemption determination with respect to such laws by that time.
- ***EU local presence requirements***: Within 24 months from signing of the Covered Agreement, EU member states are to revise existing laws so that U.S. reinsurers can operate in the EU without establishing a branch or subsidiary.
- ***Group supervision:*** The EU member states will apply the group supervision measures of the Covered Agreement following signature of the agreement and completion of the EU's internal approvals for "provisional application" of the agreement. According to the Fact Sheet released by Treasury, this is anticipated to take approximately 3 months.[3]

According to the joint statement of the U.S. and EU representatives to the negotiations, the Covered Agreement is "balanced, in the mutual interest of both the U.S. and the EU, and provides meaningful benefits for U.S. and EU insurance consumers and for U.S. and EU insurers and reinsurers that operate in both markets."

## BACKGROUND

### Covered Agreements

Title V of Dodd-Frank authorizes Treasury and the USTR to jointly negotiate and enter into covered agreements on behalf of the United States. FIO is authorized to assist Treasury in negotiating covered agreements. The term "covered agreement" under Dodd-Frank 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 substantially equivalent to the level of protection achieved under State insurance or reinsurance regulation."[4]

Before initiating negotiations, during the negotiations, and before entering into a covered agreement, Treasury and the USTR are required to jointly consult with the Congressional Committees, including consulting on the implementation of the agreement and the general effect of the agreement on existing state laws. A covered agreement may only enter into force with respect to the United States if Treasury and the USTR jointly submit the legal text of the agreement to the Congressional Committees on a day in which both Houses of Congress are in session, and a period of 90 calendar days has elapsed from the date of such submission.

Title V of Dodd-Frank provides that a covered agreement can serve as a basis for preemption of state law under certain circumstances.[5] A state insurance measure can only be preempted if the FIO Director determines that: (1) the measure results in less favorable treatment of a non-U.S. insurer domiciled in a foreign jurisdiction that is subject to a covered agreement than a U.S. insurer domiciled, licensed or admitted to do business in that state; and (2) the measure is inconsistent with a covered agreement.[6] Before a state law can be preempted, the FIO Director is required to notify and consult with the appropriate state and the USTR and to publish in the Federal Register for public comment a notice of the proposed preemption. Upon making a preemption determination, the FIO Director is then required to notify the appropriate state of the determination, establish a reasonable time for the preemption to become effective (not less than 30 days), and notify the Congressional Committees. The FIO Director is then required to publish another notice in the Federal Register and notify the appropriate state once the preemption has become effective. A state has the right to judicial review of a preemption determination pursuant to the Administrative Procedures Act, which the court must consider under a *de novo* standard of review.

The negotiations that culminated in the Covered Agreement were primarily motivated by two areas of concern: (1) the imposition by U.S. state insurance supervisors of collateral requirements on EU (and other non-U.S.) reinsurers assuming insurance obligations from U.S. ceding insurers, and (2) the potential application by EU national supervisors of Solvency II group-level solvency, capital and supervision requirements on U.S.-based insurance groups, and local presence requirements for U.S. reinsurers operating in the EU. These issues have been a focus of U.S. and EU insurance industry participants and regulators. For example, in 2012, the European Commission ("EC"), the European Insurance and Occupational Pensions Authority ("EIOPA"), the National Association of Insurance Commissioners ("NAIC") and FIO initiated the EU-U.S. Insurance Project, a joint project to enhance the understanding of each other's approach to solvency oversight and to explore ways to increase transatlantic cooperation (the Board of Governors of the Federal Reserve System later also joined the project). As part of this exercise, technical groups were formed to address confidentiality/professional secrecy; group supervision; and reinsurance. In addition, FIO has for years publicly called for a covered agreement to address reinsurance collateral reform and other prudential matters.[7]

In November 2015, as required by Dodd-Frank, Treasury and the USTR announced to the Congressional Committees their intention to begin negotiating a covered agreement with the EU. The talks began in February 2016 and concluded in January 2017. The notice to the Congressional Committees stated that state insurance regulators would have a meaningful role during the covered agreement negotiating process.[8]

### Reinsurance collateral reform in the United States

Historically, state insurance regulators in the United States have required that an unlicensed or unauthorized reinsurer, foreign or domestic, post collateral in a U.S. financial institution equal to 100% of the reinsurer's financial obligation as a means of ensuring payment of claims, and, in the case of non-U.S. reinsurers, avoiding the potential challenge of enforcing judgments in a foreign court. Capital deployed by reinsurers to satisfy these reinsurance collateral requirements is unavailable for other purposes. Accordingly, European reinsurers and their regulators have long advocated for the United States to lift reinsurance collateral requirements on EU-based reinsurers and treat them like U.S. reinsurers.[9]

In part to address these issues, in 2011 the NAIC adopted revisions to its Credit for Reinsurance Model Law and related regulations, allowing reduction of the 100% collateral requirement for reinsurers ("certified reinsurers") that are in solid financial health and subject to an effective regulatory regime (a "qualified jurisdiction"). The model law revisions provide for a sliding scale of required collateral posting for certified reinsurers, with six categories ranging from 0% required collateral for certified reinsurers with a Secure-1 rating to 100% required collateral for those with a Vulnerable-6 rating (the ratings are based on the financial strength ratings of the reinsurer from an acceptable rating agency). The NAIC has also established a peer review system for the certification of foreign reinsurers by states, which provides an opportunity for foreign reinsurers to "passport" throughout the United States.[10] The 2011 amendments to the NAIC's Credit for Reinsurance Model Law require an assuming insurer to be licensed and domiciled in a qualified jurisdiction in order to be eligible for certification by a state as a certified insurer; individual reinsurers are certified based on criteria that include, among other things, financial strength and timely claims payments history. According to the NAIC, as of January 2016, 32 states, representing more than 66% of direct U.S. premium, had adopted legislation to implement the revised NAIC credit for reinsurance models, and an additional five states had indicated plans to do so in the near future, which would raise the total market coverage to 93%. In addition, as of January 2016, Bermuda, France, Germany, Ireland, Japan, Switzerland and the U.K. have been placed on the NAIC's list of qualified jurisdictions, and more than 25 foreign reinsurers have been certified under the peer review system.

The NAIC has taken the position that, in light of progress made by the NAIC and the states to modernize credit for reinsurance rules, which allow foreign reinsurers certified by an adopting U.S. state to post significantly less than 100% collateral, a covered agreement to address reinsurance collateral reform is not necessary. The NAIC has also questioned whether a covered agreement will be "substantially equivalent" to the protections afforded U.S. consumers under state insurance laws.[11]

### Solvency II and equivalence

After several decades of development, Solvency II came into effect in the EU on January 1, 2016. Solvency II includes minimum capital and solvency requirements, governance requirements, risk management and public reporting standards applicable to insurers operating in the EU, as well as groupwide supervision and solvency standards that may be applied to insurance groups headquartered outside the EU that have EU operations. Solvency II authorizes the EC to make "equivalence" determinations for third countries with respect to certain areas of prudential regulation. Each of these equivalence determinations also requires that an appropriate confidentiality regime be in place. The Solvency II regime allows EU member states to supervise insurance groups that operate in the EU but are domiciled in non-equivalent countries, such as the United States, and EU member states may subject those insurers to additional capital, governance and reporting requirements.

There are three elements of a non-EU prudential regime that may be deemed equivalent by the EC:

- ***Reinsurance***: reinsurance contracts concluded with reinsurers in an equivalent jurisdiction will be treated in the same manner as contracts concluded with EU reinsurers (i.e., no collateral or local presence requirements will be imposed).
- ***Solvency assessment***: an EU insurance group may calculate the solvency of any non-EU subsidiary in an equivalent jurisdiction using the calculation methods laid down by the equivalent third country where the non-EU subsidiary is domiciled.
- ***Group supervision***: insurance groups subject to supervision by a non-EU supervisor in an equivalent jurisdiction will be exempt from certain Solvency II worldwide group-level supervision requirements.

A determination of "full equivalence" in respect of any of these elements lasts for an unlimited period of time, subject to regular review. The EC also has the power to make a decision of "provisional equivalence" or "temporary equivalence." Decisions of provisional equivalence last for a 10-year period that is renewable for further 10-year periods. To date, Switzerland and Bermuda have been granted full equivalence by the EC for all three elements,[12] while the United States, Australia, Brazil, Canada and Mexico have been granted provisional equivalence with respect to the solvency assessment alone. The provisional equivalence decision with respect to the United States, however, primarily benefits EU insurance groups with insurance operations in the United States, as it allows the EU insurance group to calculate the solvency of its U.S. subsidiaries based on state risk based capital (RBC) requirements those subsidiaries are subject to on a standalone basis in the United States.

If the EC does not adopt an equivalence decision, EU national supervisors may undertake an equivalence assessment on their own in respect of solvency assessment and group supervision, but not in respect of reinsurance. Member states also have the discretion to permit their national supervisors to apply "other methods" to ensure appropriate group-level supervision (e.g., by the non-EU insurance group establishing an intermediate holding company for its EU subsidiaries and applying the group-level requirements at the intermediate holding company level).

U.S.-based insurers have already begun to experience the potential impact of Solvency II implementation. For example, a number of EU member states have included provisions in their national Solvency II implementation that differentiate between the direct market access rights of reinsurers from "equivalent jurisdictions" and of reinsurers from "non-equivalent" third countries. Even though not technically required under Solvency II, the national laws of Germany, Belgium, Austria and Poland provide that reinsurers established in non-equivalent third countries may only conduct reinsurance business in a member state through a local branch (and subject to authorization by the national supervisor). Some U.S.-based reinsurers have already received letters from the German supervisor, BaFin, requiring them to set up a German branch if they wish to continue conducting reinsurance business in Germany. In addition, the Prudential Regulatory Authority in the U.K., the PRA, issued a supervisory statement providing that, in the absence of equivalent group supervision, the PRA may decide to apply either the relevant Solvency II requirements to the worldwide group as if it were based in the EU, or it may use "other methods" as permitted under Solvency II.[13] The PRA has already required some U.S.-based insurance groups with operations in the U.K. to submit an in-depth waiver application requesting the use of "other methods."[14]

It remains to be determined whether the Covered Agreement, once it has entered into force, will require or result in, or rather be a substitute for, a formal "full equivalence" determination with respect to the United States. It also remains unclear what effect, if any, the implementation of the Covered Agreement will have with respect to group solvency and reinsurance requirements between the United States and jurisdictions deemed equivalent by the EC (such as Switzerland and Bermuda), or between the United States and the U.K. once the U.K.'s exit from the EU (Brexit) takes effect. Finally, implementation and application of the Covered Agreement may be affected as a consequence of any reforms or other actions taken with respect to Dodd-Frank by the incoming United States administration and Congress.

## THE COVERED AGREEMENT

### A. REINSURANCE

#### Elimination of collateral requirements

Subject to the conditions summarized below, each party to the Covered Agreement (i.e., the EU and the United States) agrees to ensure that its supervisory authorities do not:

- maintain or adopt any requirement that an assuming reinsurer which has its head office or is domiciled in the territory of the other party (a "home party reinsurer") post collateral in connection with cessions to it from a ceding insurer which has its head office or is domiciled in the party's own territory (a "host party cedent"), as a condition to either (1) allowing the home party reinsurer to enter into a reinsurance agreement with the host party cedent or (2) allowing the host party cedent to take credit for reinsurance or for risk mitigation effects of reinsurance agreements[15] concluded with the home party reinsurer; or
- maintain or adopt any new requirement with substantially the same regulatory impact on the home party reinsurer as such collateral requirements.

The Covered Agreement provides that the above requirements only apply where the collateral requirements (or similar new requirements) result in less favorable treatment of home party reinsurers than assuming reinsurers domiciled or headquartered in the same territory as the host party cedent. The prohibitions also apply to any related collateral reporting requirements.

Once implemented, the above requirements will prohibit, for example, U.S. state insurance regulators from requiring EU reinsurers to post collateral as a condition for U.S. cedents to obtain credit for reinsurance in respect of reinsurance agreements with EU reinsurers.

These provisions do not, however, prohibit host party supervisory authorities from applying requirements for entering into reinsurance agreements or taking credit for reinsurance or risk mitigation effects of reinsurance if the same requirements apply to reinsurance agreements between cedents and reinsurers domiciled or headquartered in the host party's territory.[16]

### Elimination of local presence requirements

Subject to the conditions summarized further below, each party to the Covered Agreement agrees to ensure that its supervisory authorities do not:

- maintain or adopt any requirement for a home party reinsurer to have a local presence as a condition to either (1) allowing the home party reinsurer to enter into a reinsurance agreement with the host party cedent or (2) allowing the host party cedent to take credit for reinsurance or for risk mitigation effects of reinsurance agreements concluded with the home party reinsurer; or
- maintain or adopt any new requirement with substantially the same regulatory impact on the home party reinsurer as local presence.

The above requirements apply only where the local presence requirements (or similar new requirements) result in less favorable treatment of home party reinsurers than assuming reinsurers that are domiciled or headquartered in the same territory as the host party cedent, and that are licensed, admitted or permitted to operate in such territory.

Once implemented, the above requirements will prohibit, for example, EU insurance regulators from requiring U.S. reinsurers to maintain a local branch or establish a new subsidiary in the applicable EU member state as a condition for U.S. reinsurers to enter into reinsurance agreements with EU cedents.

### Conditions to application of Article 3

The above prohibitions on applying reinsurance collateral or local presence requirements are subject to the assuming reinsurer meeting the following conditions:[17]

- ***Minimum capital and solvency standards:*** assuming reinsurers are required to have and maintain on an ongoing basis (1) own funds or capital and surplus, calculated according to the methodology of the reinsurer's home jurisdiction, of €226 million for EU reinsurers, or $250 million for U.S. reinsurers; and (2) for EU reinsurers, a 100% Solvency Capital Ratio under Solvency II, or, for U.S. reinsurers, a Risk Based Capital (RBC) of 300% Authorized Control Level. The assuming reinsurer must agree to provide prompt written notice to the supervisory authority of the ceding insurer if it falls below such applicable minimum capital/surplus or solvency or capital ratios, or if any regulatory action is taken against it for "serious noncompliance with applicable law."
- ***Reporting obligations:*** if requested by the host supervisory authority, the assuming reinsurer must provide specified documentation to the authority, including: annual audited financial statements, and solvency and financial condition reports (as required under Solvency II) or

actuarial opinions (as required in the United States), in each case for the two years prior to entry into the applicable reinsurance agreement and annually thereafter; semi-annual lists of all disputed and overdue reinsurance claims outstanding for 90 days or more for reinsurance assumed from cedents in the cedent's jurisdiction; and semi-annual lists relating to assumed reinsurance and ceded insurance, and reinsurance recoverables on paid and unpaid losses by the assuming reinsurer.

- ***Prompt claims paying practice:*** the assuming reinsurer must maintain a practice of prompt payment of reinsurance claims. The Covered Agreement specifies the criteria for determining a lack of prompt payment (e.g., more than 15% of reinsurance recoverables are overdue and in dispute).
- ***No resolution proceedings:*** the assuming reinsurer must confirm it is not subject to any solvent scheme of arrangement, or resolution or receivership proceedings, and must provide 100% collateral to the ceding insurer for outstanding reinsurance liabilities if it is.
- ***Consent to jurisdiction and related requirements:*** other conditions for assuming reinsurers include consent to jurisdiction and service of process in the host jurisdiction, and commitment to the payment of final, enforceable judgments. The assuming reinsurer must also agree in each reinsurance agreement subject to the Covered Agreement that it will provide collateral for 100% of the reinsurance liabilities if the reinsurer resists the enforcement of a final judgment.

The Covered Agreement provides that if a home party reinsurer no longer satisfies one of the above conditions, the host supervisory authority may impose any of the otherwise prohibited reinsurance collateral or local presence requirements, subject to specified notice requirements and allowing the reinsurer time to submit a remediation plan (30 days absent exceptional circumstances) and to remedy the defect (90 days from the initial notice absent exceptional circumstances).

The Covered Agreement terms will only apply to reinsurance agreements entered into, amended or renewed on or after the date on which an insurance law or regulation reducing the collateral in accordance with the Covered Agreement takes effect in the applicable host jurisdiction, and only with respect to losses incurred and reserves reported from and after the later of (1) the date of the insurance law or regulation and (2) the effective date of the new reinsurance agreement, amendment or renewal.

## B. GROUP SUPERVISION

The Covered Agreement sets forth practices and precepts of group supervision to be followed by the parties to the Covered Agreement. The basic rule provides that, subject to various exceptions noted below, (1) an insurance or reinsurance group is subject only to worldwide prudential insurance group supervision (including worldwide group governance, solvency, capital and reporting requirements) by the supervisory authorities of the jurisdiction where the worldwide parent of the group is domiciled or headquartered (the "home supervisor"); and (2) the worldwide parent of the insurance group is not subject to group supervision by any supervisory authority from the territory in which the insurance group has operations, but which is not the territory where the worldwide parent is domiciled or headquartered (the "host supervisor"). Thus, a U.S. insurance group operating in the EU will be subject to worldwide group-level insurance prudential supervision only by its applicable primary U.S. insurance regulator(s).

In addition to the exceptions noted below, the Covered Agreement makes clear that host supervisors may exercise group supervision at the level of the parent undertaking or company domiciled in its territory, even though the ultimate parent at the worldwide level may be domiciled in the home supervisor's territory. For example, if a U.S.-based insurance group has one or more subsidiaries licensed or domiciled in the EU (or an EU intermediate holding company with multiple EU insurance subsidiaries), the EU insurance supervisor may apply group supervision requirements to the top-tier entity domiciled or licensed in the EU.

The Covered Agreement includes various exceptions under which some level of group supervision by host supervisors may be permissible:

- ***ORSA requirements:*** If the home supervisor requires a worldwide group Own Risk and Solvency Assessment ("ORSA"), the home supervisor must provide a summary of the worldwide group ORSA to the host supervisor (automatically if the host supervisor is a member of the insurance group's supervisory college, and otherwise upon request by the relevant host supervisor). If no worldwide ORSA is required, the home supervisor must provide equivalent documentation.[18] If the summary of the worldwide ORSA or equivalent documentation presents any serious threat to policyholder protection or financial stability in the territory of the host supervisor, the host supervisor may impose preventive, corrective or other measures to insurers in the host territory, subject to consultation with the home supervisor and with the applicable supervisory college.
- ***Other reporting requirements:*** Host supervisors retain the ability to request and obtain information or require reports (including at the level of the worldwide parent) if the information or reports directly relate to the risk of a serious impact on the ability of the subsidiaries of the insurance group to pay claims in the host territory, or where the information is deemed necessary to protect against serious harm to policyholders or a serious threat to financial stability. Failure to comply with information requests may result in preventive or corrective measures being imposed by the host supervisor within the host territory.
- ***Group capital assessment:*** Of particular significance, the host supervisor may not impose a group capital assessment or requirement at the level of the worldwide parent, but only if the insurance group is subject to a group capital assessment imposed by the home supervisor. The group capital assessment of the home supervisor must include a worldwide group capital calculation capturing risk at the level of the entire group, and the home supervisor must have the authority to impose preventive, corrective or otherwise responsive measures on the basis of the assessment, including the authority to impose capital measures where appropriate. Although the NAIC has amended its holding company model laws to authorize the collection of group-level capital information from U.S.-based insurance groups, many state insurance holding company laws arguably do not presently authorize the insurance supervisor of a U.S.-based insurance group to impose group-level capital requirements at the worldwide parent level. The NAIC is, however, in the process of developing a group capital calculation that would be applicable to U.S.-based internationally active insurance groups.[19] Solvency II does require a group-level capital assessment and solvency requirement for EU-based insurance groups.

  Article 10 of the Covered Agreement[20] provides that, for 60 months after the date of provisional application of the agreement, supervisory authorities in the EU shall not impose a group capital requirement at the level of the worldwide parent with regard to a U.S. insurance group with operations in the EU. After the end of such 60-month period, however, EU insurance supervisors would be able to impose a group level capital assessment or requirement at the level of the U.S.-based worldwide parent if state insurance laws applicable to U.S. insurance groups are not then viewed as sufficient to include the authority to impose a group capital assessment and requirement,.

- ***Conflict with banking and other laws:*** The Covered Agreement makes clear that the above group supervision limitations and restrictions are not intended to limit or restrict the ability of EU or U.S. supervisory authorities to exercise supervisory or regulatory authority over groups or entities that own or control credit operations or depository institutions, or have banking operations, in the EU or United States, as applicable, or the distress or activities of which have been determined could pose a threat to the financial stability of the EU or United States under applicable law (e.g., have been subject to so-called "SIFI" designation).

## C. EXCHANGE OF INFORMATION, JOINT COMMITTEE AND TERMINATION

The Covered Agreement encourages, in a non-binding manner, insurance supervisors in the United States and the EU to exchange information. An annex to the Covered Agreement provides model provisions for a memorandum of understanding on information exchange that insurance supervisors are encouraged to adopt. The model memorandum of understanding addresses cooperation between supervisors, the request for and use of provided information, and the treatment of confidential information.

The Covered Agreement also establishes a joint committee, composed of representatives of the United States and EU, as a forum for consultation and to exchange information on the administration and implementation of the agreement.

Following mandatory consultation, either party may terminate the Covered Agreement at any time by giving written notice to the other party. In particular, the parties may terminate the agreement where either party has failed to fulfil its obligations or has taken measures inconsistent with the agreement. The Covered Agreement provides for when mandatory consultation may be required, including prior to the termination of the agreement.

## D. IMPLEMENTATION AND APPLICATION

### Entry into force

The Covered Agreement will enter into force seven days after the date the parties exchange written notifications certifying that they have completed their respective internal requirements and procedures, or as otherwise agreed.

### Implementation of the agreement

From the date of entry into force or provisional application of the agreement, whichever is earlier, the parties will take all measures to implement and apply the agreement, and will encourage relevant authorities to refrain from taking any measures which are inconsistent with the agreement (including with respect to collateral and local presence requirements). ("Provisional application" is not defined in the Covered Agreement.)

From the same date, the United States will encourage each state to promptly (1) adopt measures to reduce, in each year following such date, the amount of collateral required by each state to allow full credit for reinsurance by 20% of the collateral required as of the year in which the agreement is signed; and (2) adopt and implement credit for reinsurance laws and regulations consistent with the provisions of the Covered Agreement relating to elimination of collateral requirements. As noted below, the elimination of reinsurance collateral requirements is to be implemented and fully applicable in the territories of both parties no later than 60 months from the date of signing of the agreement.

As noted earlier, provided the agreement has entered into force, 42 months after the agreement is signed, the United States will begin the process of evaluating a potential preemption determination with respect to any state insurance measure that FIO determines is inconsistent with the Covered Agreement and results in less favorable treatment of non-U.S. insurers subject to the Covered Agreement than a U.S. insurer domiciled, licensed or otherwise admitted in the state. The United States must complete any necessary preemption determination on a date no later than the first day of the month 60 months after the signature of the agreement. States with the highest volume of gross ceded reinsurance are to be prioritized for purposes of potential preemption determinations.

### Application of the agreement

The Covered Agreement imposes, on a provision-by-provision basis, specific timelines for implementation of the agreement and establishes cross-conditionality between provisions.

- ***Cross-conditionality:*** On the date of entry into force, or 60 months from signing of the agreement, whichever is later, the obligations of a party under Article 3 relating to the elimination of reinsurance collateral and Article 9 (governing implementation of the agreement) will be applicable only if, and for as long as, the supervisory authorities of the other party exercise supervision as required under the group supervision requirements of the agreement and those relating to the elimination of local presence requirements. Similarly, the obligations of a party relating to group supervision and the elimination of local presence requirements will only be applicable if, and for as long as, the other party satisfies its obligations regarding elimination of reinsurance collateral and group supervision.
- The EU will provisionally apply the group supervision requirements and practices until the date of entry into force and then apply those provisions thereafter by *ensuring* that supervisory authorities comply with those provisions from the seventh day of the month following the date on which the parties have notified each other that their internal requirements and procedures necessary for the *provisional application* of the agreement have been completed.
- The United States will provisionally apply the group supervision requirements and practices until the date of entry into force and then apply those provisions thereafter by *using best efforts and encouraging* supervisory authorities to comply with those provisions from the seventh day of the month following the date on which the parties have notified each other that their internal requirements and procedures necessary for the *provisional application* of the agreement have been completed.
- Until the date of entry into force, or 60 months from signing of the agreement, whichever is later, the Article 3 provisions on elimination of reinsurance collateral will apply with respect to a EU reinsurer in a state in the United States on the earlier of (1) adoption by the relevant state of a measure consistent with Article 3; or (2) the effective date of a preemption determination with respect to the state.
- From the date of provisional application of the agreement and for 60 months thereafter, supervisory authorities in the EU will not impose a group capital requirement at the level of the worldwide parent of an insurance group with regard to a U.S. insurance group with operations in the EU.

- From the date of signature of the agreement and for 60 months thereafter, if a party does not meet the obligations of Article 3 with respect to the elimination of local presence requirements, the supervisory authorities of the other party may, after mandatory consultation, impose a group capital assessment or requirement at the level of the worldwide parent domiciled in the other party's territory.
- The Article 3 provisions on elimination of local presence requirements will be implemented and applicable in the EU no later than 24 months from the date of signature of the agreement, provided the agreement has been provisionally applied or has entered into force.
- The Article 3 provisions on elimination of reinsurance collateral requirements will be implemented and fully applicable in the territories of both parties no later than 60 months from the date of signing of the agreement, provided the agreement has entered into force.
- In the event measures are applied by U.S. supervisory authorities outside the United States to an EU insurance group the distress or activities of which the Financial Stability Oversight Council has determined could pose a threat to the financial stability of the United States, either party may terminate the agreement under an accelerated mandatory consultation and termination. Termination is similarly permitted in the event measures are applied by EU supervisory authorities outside the EU to a U.S. insurance group in relation to a threat to the financial stability of the EU.
- The provisions relating to the joint committee, termination and mandatory consultation, and amendments are to be applied from the date of entry into force or provisional application of the agreement, whichever is earlier.

*   *   *

## ENDNOTES

1 U.S. Department of the Treasury, Press Release: *Treasury, USTR Successfully Complete Negotiations for a Covered Agreement with the European Union* (January 13, 2017), *available at* https://www.treasury.gov/press-center/press-releases/Pages/jl0705.aspx. Treasury and USTR sent, also on January 13, 2017, letters to certain Congressional committees informing them that covered agreement negotiations have been completed. The text of the letters, as well as the final legal text of the agreement, is available at https://www.treasury.gov/initiatives/fio/Documents/Final%20Covered%20Agreement%20Letters%20to%20Congress%20Full%20Text.pdf.

2 *Joint Statement on the U.S.-EU Negotiations for a Bilateral Agreement on Insurance and Reinsurance Measures* (January 13, 2017), *available at* https://www.treasury.gov/press-center/press-releases/Pages/jl0706.aspx.

3 U.S. Department of the Treasury, *Fact Sheet: Bilateral Agreement between the European Union and the United States of America On Prudential Measures Regarding Insurance and Reinsurance* (January 13, 2017), *available at* https://www.treasury.gov/initiatives/fio/reports-and-notices/Documents/Covered-Agreement-Fact-Sheet-(011317)-FINAL.PDF.

4 Under Title V of Dodd-Frank, "substantially equivalent to the level of protection achieved" means "the prudential measures of a foreign government, authority, or regulatory entity achieve a similar outcome in consumer protection as the outcome achieved under State insurance or reinsurance regulation."

5 Under the McCarran-Ferguson Act (15 U.S.C. §§ 1011-1015), passed by Congress in 1945, state laws governing the business of insurance cannot be invalidated, preempted, impaired or superseded by any federal law unless the federal law specifically relates to the business of insurance. As a general matter, there is no formal mechanism in the United States for the federal government to compel states to implement insurance laws or regulations. In the event a state insurance law conflicts with the terms of a covered agreement, the United States will need to rely on federal preemption.

6 Under Dodd-Frank, not all insurance regulatory measures can be preempted. For example, state laws and regulations governing rates, premiums, sales practices, insurance coverage requirements, and state antitrust laws relating to insurance cannot be preempted.

7 *See*, for example, FIO, *How to Modernize and Improve the System of Insurance Regulation in the United States*, completed pursuant to Title V of Dodd-Frank (December 2013), *available at* https://www.treasury.gov/initiatives/fio/reports-and-notices. *See also* S&C publication, *Federal Insurance Office Report: The Federal Insurance Office Releases Report on How to Modernize and Improve Insurance Regulation in the United States* (December 16, 2013), *available at* https://sullcrom.com/Federal_Insurance_Office_Report.

8 Department of the Treasury, United States Trade Representative, *Notice of Intent To Initiate Covered Agreement Negotiations With the European Union* (November 20, 2015), *available at* https://www.federalregister.gov/documents/2016/01/19/2016-00856/notice-of-intent-to-initiate-covered-agreement-negotiations-with-the-european-union. The Notice stated that negotiations would seek to address: (1) obtaining treatment of the U.S. insurance regulatory system by the EU as equivalent; (2) obtaining recognition by the EU of the integrated state and federal regulatory and oversight system in the United States, including with respect to group supervision; (3) facilitating exchange of confidential regulatory information between lead insurance supervisors; (4) affording nationally uniform treatment of EU-based reinsurers operating in the United States, including with respect to collateral requirements; and (5) obtaining permanent equivalent treatment for the solvency regime in the United States as applicable to insurance and reinsurance operations.

9 According to FIO, reinsurers owned by groups headquartered or domiciled outside the United States accounted for approximately 92% of reinsurance premiums ceded by U.S.-based insurers

## ENDNOTES (CONTINUED)

in 2013; a significant proportion of these non-U.S. reinsurers are domiciled in the EU. *See*, FIO, *The Breadth and Scope of the Global Reinsurance Market and the Critical Role it Plays in Supporting Insurance in the United States* (February 11, 2015), *available at* https://www.treasury.gov/initiatives/fio/reports-and-notices/Documents/FIO%20-%20Reinsurance%20Report.pdf.

10 "Passporting" refers to the process under which a state has the discretion to defer to the certification of a reinsurer and the rating assigned to that certified reinsurer by another state.

11 *See* http://www.naic.org/cipr_topics/topic_covered_agreement.htm.

12 Japan has been granted provisional equivalence for solvency assessment and temporary equivalence for reinsurance.

13 Bank of England, Prudential Regulation Authority, *Supervisory Statement* | *SS9/15, Solvency II: group supervision* (March 2015), *available at* http://www.bankofengland.co.uk/pra/Documents/publications/ss/2015/ss915.pdf.

14 See, for example, NAIC, *Effect of Solvency II on Qualified Jurisdiction Status* (December 6, 2016), *available at* http://www.naic.org/documents/cmte_e_reinsurance_exposure_effect_solv_qual_jur_stat.pdf.

15 Under the Covered Agreement, "credit for reinsurance or credit for risk mitigation effects of reinsurance agreements" means "the right of a ceding insurer under prudential regulatory framework to recognize amounts due from assuming reinsurers relating to paid and unpaid losses on ceded risks as assets or reductions from liabilities respectively." Article 2, Clause (c).

16 For example, state insurance regulations relating to credit for reinsurance typically require any reinsurance agreement, whether the reinsurer is licensed or admitted in the state or not, to include certain clauses relating to insolvency, e.g., so-called "cut-through" clauses.

17 Treasury has stated that the Covered Agreement builds on the reinsurance collateral reform adopted by the NAIC in 2011 (through amendments to the Credit for Reinsurance Model Law) and implemented in many states. The Covered Agreement requirements, according to Treasury, "provide a substantially equivalent level of protection for ceding insurers and consumers to that which is currently provided by U.S. state laws regarding credit for reinsurance." Treasury, *Fact Sheet: Bilateral Agreement between the European Union and the United States of America On Prudential Measures Regarding Insurance and Reinsurance* (January 13, 2017). While certain of the conditions for the elimination of reinsurance collateral and local presence requirements are substantially similar to the NAIC's amendments to the Credit for Reinsurance Model Law (e.g., the minimum capital and surplus requirement and prompt payment of reinsurance claims), current credit for reinsurance laws (unlike the Covered Agreement) provide for a sliding scale of required collateral posting depending on a reinsurer's financial strength rating.

18 The Covered Agreement provides that the summary of any worldwide ORSA, or equivalent documentation, must include a description of the insurance group's risk management framework, an assessment of its risk exposure, and a group assessment of risk capital and a prospective solvency assessment.

19 *See* NAIC, *CDAWG Group Capital Calculation Recommendation*, available at http://www.naic.org/cmte_e_grp_capital_wg.htm.

20 Article 10 (Application of the Agreement), Section 10.2(e).

## ABOUT SULLIVAN & CROMWELL LLP

Sullivan & Cromwell LLP is a global law firm that advises on major domestic and cross-border M&A, finance, corporate and real estate transactions, significant litigation and corporate investigations, and complex restructuring, regulatory, tax and estate planning matters. Founded in 1879, Sullivan & Cromwell LLP has more than 875 lawyers on four continents, with four offices in the United States, including its headquarters in New York, three offices in Europe, two in Australia and three in Asia.

## CONTACTING SULLIVAN & CROMWELL LLP

This publication is provided by Sullivan & Cromwell LLP as a service to clients and colleagues. The information contained in this publication should not be construed as legal advice. Questions regarding the matters discussed in this publication may be directed to any of our lawyers listed below, or to any other Sullivan & Cromwell LLP lawyer with whom you have consulted in the past on similar matters. If you have not received this publication directly from us, you may obtain a copy of any past or future related publications from Michael B. Soleta (+1-212-558-3974; soletam@sullcrom.com) in our New York office.

## CONTACTS

| | | |
|---|---|---|
| **New York** | | |
| Robert G. DeLaMater | +1-212-558-4788 | delamaterr@sullcrom.com |
| Robert M. Fettman | +1-212-558-4751 | fettmanr@sullcrom.com |
| C. Andrew Gerlach | +1-212-558-4789 | gerlacha@sullcrom.com |
| Roderick M. Gilman Jr. | +1-212-558-3277 | gilmanr@sullcrom.com |
| Stephen M. Kotran | +1-212-558-4963 | kotrans@sullcrom.com |
| Marion Leydier | +1-212-558-7925 | leydierm@sullcrom.com |
| William D. Torchiana | +1-212-558-4056 | torchianaw@sullcrom.com |
| **Washington, D.C.** | | |
| Samuel R. Woodall III | +1-202-956-7584 | woodalls@sullcrom.com |
| **London** | | |
| Ben Perry | +44-20-7959-8477 | perryb@sullcrom.com |
| **Paris** | | |
| William D. Torchiana | +33-1-7304-5890 | torchianaw@sullcrom.com |
| **Tokyo** | | |
| Keiji Hatano | +81-3-3213-6171 | hatanok@sullcrom.com |
| **Hong Kong** | | |
| Garth W. Bray | +852-2826-8691 | brayg@sullcrom.com |