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NAIC holds first hearing on EU-U.S. covered agreement reinsurance collateral elimination

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The National Association of Insurance Commissioners ("NAIC") held a much-anticipated public hearing in New York City on 20 February 2018 to consider how U.S. states should address the elimination of reinsurance collateral requirements for EU reinsurers of U.S. insurance business that qualify under the bilateral agreement between the U.S. and the EU (the so-called "Covered Agreement"), which was signed on 22 September 2017.

The NAIC requested public comments on the six points set forth below regarding implementation of the Covered Agreement's collateral reduction requirement. Twenty comment letters were submitted by insurers, reinsurers, and insurance industry groups in response to this request, and many of them also presented oral comments at the public hearing.

The areas that generated the greatest degree of interest, both in the comment letters and at the hearing, concerned whether the reinsurance collateral elimination provisions provided to the EU under the Covered Agreement should be extended to NAIC "Qualified Jurisdictions" that are not EU member states--currently, Bermuda, Switzerland and Japan--and to other non-U.S. jurisdictions covered by potential future covered agreements. NAIC Qualified Jurisdictions include seven non-U.S. jurisdictions (four from the EU) approved by the NAIC for reduced reinsurance collateral on a sliding scale for reinsurers from such jurisdictions that satisfy certain "certified" (mostly financial strength-based) criteria. As described below, while the majority of comments supported extending the collateral reduction provisions of the Covered Agreement to non-EU NAIC Qualified Jurisdictions and other non-U.S. jurisdictions, principally to "level the playing field," the NAIC was strongly urged to ensure the U.S. state-based insurance system in turn received reciprocal value from those jurisdictions in the form of explicit recognition of the U.S. group supervision and group capital regime and as leverage to resolve other potential cross-border issues that may impact U.S. insurance groups.

Commenters were also very focused on the NAIC question of whether additional "guardrails" were needed for U.S. cedents on account of the elimination of collateral under the Covered Agreement and the potential increased financial solvency risks resulting therefrom, with the near unanimous consensus being that such was not necessary at this juncture.

The following summarizes the key takeaways from the hearings and next steps planned by the NAIC.

1. **Amending the Credit for Reinsurance Model Law (#785) and the Credit for Reinsurance Model Regulation (#786) (the "Reinsurance Models") to eliminate reinsurance collateral requirements for EU-based reinsurers meeting the conditions of the Covered Agreement.**

The overwhelming consensus at the hearing was that the collateral elimination requirements of the Covered Agreement should be implemented by revision to the Reinsurance Models as opposed to promulgating a new regulatory regime to accommodate the Covered Agreement.

Under the Covered Agreement, U.S. States will need to consider action with respect to reinsurance collateral reforms within 60 months or be subject to potential federal preemption. In light of this significant deadline, the NAIC President and Commissioner of the Tennessee Department of Commerce and Insurance, Julie Mix McPeak, announced that the NAIC will pursue an aggressive timeline, aiming to submit draft revisions to the Reinsurance Models to be considered at the 2018 Summer National Meeting in Boston and approve revisions to the Models by the 2018 Fall National Meeting in San Francisco. Insurance industry attendees generally reacted positively to the news of this anticipated timeline, but at least one regulator privately expressed concern that this timeline may not allow adequate time for consideration of the issues raised by the Covered Agreement.

Comments were also presented regarding implementation of the 20% annual reduction in required collateral encouraged by the Covered Agreement (such that collateral requirements for EU reinsurers would go from 100% to 0% over the next 5 years). One industry comment suggested that the existing Reinsurance Models may provide sufficient room for interpretation to gradually relax collateral requirements in anticipation of amendments to the Reinsurance Models.

2. **Extending similar treatment to reinsurers from other jurisdictions covered by potential future covered agreement(s) that might be negotiated pursuant to the Dodd-Frank Wall Street Reform and Consumer Protection Act.**

While potential future covered agreements were not favored by most present industry members, the industry consensus at this stage appears to be in favor of creation of a mechanism that will allow for implementation of any future covered agreements without further state legislative action due to legislative fatigue surrounding credit for reinsurance issues.

Some commenters raised the possibility of non-EU countries acceding to the Covered Agreement and thereby becoming subject to its terms, including its collateral elimination requirements. Although an accession process does not currently exist, it could be permissible under the Dodd-Frank Wall Street Reform and Consumer Protection Act. Others argued that future covered agreements would be unnecessary if the NAIC were to extend collateral elimination to all NAIC Qualified Jurisdictions, as discussed below in Point 3.

3. **Providing reinsurers domiciled in NAIC Qualified Jurisdictions with similar reinsurance collateral requirements.**

Predictably, industry comments from reinsurers in Qualified Jurisdictions outside of the EU-- currently Bermuda, Switzerland and Japan-- advocated for an extension of the elimination of required collateral to reinsurers in those jurisdictions. Reinsurers in these jurisdictions (which under the current Reinsurance Models can qualify for collateral reduction on a sliding scale based on various financial strength criteria) argued that failure to extend the Covered Agreement's collateral elimination provisions to reinsurers in jurisdictions with equally rigorous insurance regulatory systems would give EU reinsurers an unfair advantage in the marketplace over reinsurers domiciled in other Qualified Jurisdictions. These industry commenters generally recognized that any extension of collateral elimination to non-EU countries should be accompanied by an assumption of the obligations imposed on the EU under the Covered Agreement regarding worldwide group supervision,

acceptance of the U.S. group capital assessment, and elimination of local presence requirements.
Some industry representatives, including those from U.S. insurance companies, urged the NAIC to refrain from extending collateral elimination to jurisdictions outside the EU. One concern shared by industry representatives on this side of the debate was the importance and difficulty of obtaining recognition of the U.S. insurance regulatory system by the EU, which was a key concession secured by the U.S. during negotiation of the Covered Agreement in exchange for the U.S. agreement on collateral elimination, and that the U.S. should not simply "give away" collateral relief without receipt of "fair value" from other jurisdictions in return. Some regulators expressed concern that a prohibition on states entering into treaties with foreign countries may prevent the NAIC from entering into agreements necessary to obtain mutual recognition in connection with required collateral elimination. However, it was suggested by some in the industry that the NAIC could utilize existing or new Memoranda of Understanding with relevant countries to obtain mutual recognition.

Superintendent Maria Vullo of the New York Department of Financial Services and Chair of the Reinsurance (E) Task Force questioned whether it would be a competitive disadvantage to grant collateral elimination to the EU but not the other Qualified Jurisdictions when some members of the EU may have weaker insurance regulatory systems than the current Qualified Jurisdictions.

4. Considering changes to the criteria for evaluating whether a jurisdiction should be a Qualified Jurisdiction.

At the hearing, there was no clear consensus from the industry with respect to details regarding practical implementation of the Covered Agreement. Of those industry members that favor extension of collateral elimination to non-EU countries, some members proposed creation of a new category of reinsurers and jurisdictions to contain the Covered Agreement mutual recognition requirements while others proposed revision of the definitions of Certified Reinsurer and Qualified Jurisdiction to effectuate a transformation of the old Certified Reinsurer category into a new category encompassing qualifying EU reinsurers under the Covered Agreement and qualifying non-EU reinsurers in other existing Qualified Jurisdictions.

5. Considering additional "guardrails" relative to U.S. ceding companies, such as changes to the risk-based capital (RBC) formula or new regulatory approaches to help address the increased financial solvency risks caused by the elimination of reinsurance collateral.

At the opening of the hearing, New York Superintendent Vullo noted that the NAIC requested comments regarding the necessity of additional guardrails for ceding insurers, such as changes to Risk Based Capital requirements, because collateral elimination under the Covered Agreement creates additional solvency risk and regulators must continue to protect the financial interests of United States policyholders and ceding insurers. At a separate point in the hearing, Superintendent Vullo suggested that risks associated with collecting judgments from foreign reinsurers support the need for additional guardrails on U.S. ceding insurers.

The broad consensus from insurers, reinsurers, and industry groups at the hearing was that additional guardrails are either unnecessary or should be considered with caution. Some industry members noted that additional guardrails may violate the Covered Agreement's prohibition on the adoption of any new requirement with substantially the same regulatory impact as the collateral requirement. Further, numerous comments were presented regarding the sufficiency of the 2017 revisions to the Property and Casualty Risk Based Capital framework to address U.S. ceding insurers' credit risk from reinsurance recoverables. Several members of the industry also argued that, because the 2017 revisions have not yet gone live, regulators should not rush to create additional guardrails before identifying a specific regulatory gap.

6. Any other considerations to weigh as part of the states’ implementation of the Covered Agreement.

Several U.S. insurers suggested that the revisions to the Reinsurance Models implementing the Covered Agreement expressly provide that the elimination of required collateral applies only prospectively and does not apply to reinsurance agreements entered into prior to implementation of the Covered Agreement, especially considering the concern that some EU countries or reinsurers may already view the Covered Agreement as applying retrospectively despite the language to the contrary in the U.S. Signing Statement.

Several US insurers also commented that implementation of the Covered Agreement should include a mechanism to ensure that breach of the Covered Agreement by an EU member results in loss of the collateral elimination advantage as quickly as possible. However, states may not have authority to “snap back” collateral elimination without a determination by the Joint Committee that a country has breached the Covered Agreement.

In addition, U.S. insurers want to ensure that the revised Reinsurance Models do not prevent ceding insurers’ from negotiating collateral requirements from EU reinsurers as a contractual matter.

We expect further discussion regarding implementation of the Covered Agreement will take place at the 2018 Spring National Meeting in Milwaukee.

This Insurance Update is a summary for guidance only and should not be relied on as legal advice in relation to a particular transaction or situation. If you have any questions or would like any additional information regarding this matter, please contact your relationship partner at Hogan Lovells or the lawyers listed on this update.

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