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Phone: +1 646 783 7100 | Fax: +1 646 783 7161 | customerservice@law360.com

The Clock Is Ticking For US Reinsurance Credit Laws

By **David Alberts, Lawrence Hamilton, Frank Monaco and Jay Kallas**
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David Alberts

Lawrence Hamilton

Frank Monaco

Jay Kallas

On Sept. 22, 2017, nearly two years after negotiations began, the U.S. Department of the Treasury, the U.S. Trade Representative and the European Union executed the bilateral agreement between the United States of America and the European Union on prudential measures regarding insurance and reinsurance (commonly referred to as the "covered agreement"). While the covered agreement finalizes the approaches agreed upon between the U.S. and the EU regarding several areas of insurance regulation that have long been a source of controversy, including reinsurance collateral requirements, group supervision, the exchange of information between regulators and local presence requirements in the EU, this article focuses on the impact of the covered agreement on reinsurance collateral requirements.

Background

Title V of the Dodd-Frank Act, which established the Federal Insurance Office (FIO) within the Treasury, granted the FIO the authority to coordinate federal efforts and develop federal policy on prudential aspects of international insurance matters. The FIO was empowered to negotiate arrangements (referred to as covered agreements) with one or more foreign authorities that achieve a level of protection for U.S. insurance or reinsurance consumers substantially equivalent to the level of protection achieved under the U.S. state insurance regulatory system. The FIO was also given the authority to determine whether such covered agreements will preempt state insurance laws and regulations. In its initial report on the state of the U.S. insurance system mandated by Dodd-Frank and released in December 2013, the FIO recommended pursuing a covered agreement for reinsurance collateral requirements based on the most current version of the National Association of Insurance Commissioners' (NAIC) Credit for Reinsurance Model Law and Credit for Reinsurance Model Regulation. The U.S. Trade Representative and FIO initially notified Congress of their intent to negotiate a covered agreement with the EU in November 2015.

State insurance laws have already somewhat eased collateral posting requirements for certain highly rated reinsurers that are domiciled in certain non-U.S. jurisdictions. Specifically, in 2011, the NAIC amended its Credit for Reinsurance Model Law and Credit for Reinsurance Model Regulation to reduce the collateral requirements for unauthorized reinsurers that complete a special certification process. Prior to the amendments, reinsurers that were not authorized or accredited in the ceding insurer's domiciliary jurisdiction were generally required to post 100 percent collateral for the liability being assumed. The amendments (which have been adopted in a majority of U.S. states) allow unauthorized reinsurers that have been certified by the ceding insurer's domiciliary regulator to post a reduced percentage of collateral (determined on a sliding scale) based on their financial strength (including minimum capitalization of $250 million and ratings issued by two nationally recognized rating agencies) and business practices. As explained below, the collateral reduction provisions in the covered agreement, which will apply only to EU-based reinsurers, are broader than the certified reinsurer provisions because they would completely eliminate the collateral requirement (as opposed to reducing it on a sliding scale) and because the financial strength parameters are less stringent.

Covered Agreement Provisions on Reinsurance

Under the covered agreement's terms, a "host jurisdiction" (e.g., any state in the U.S.) may not condition a local ceding insurer's entry into, or prohibit such an insurer from taking credit for liabilities ceded under, a reinsurance agreement with a reinsurer domiciled in the "home jurisdiction" (e.g., a member state within the EU) or impose collateral requirements or local presence requirements with respect to the reinsurer which result in less favorable treatment than reinsurers domiciled in the host jurisdiction would receive.

The provisions relating to reinsurance in the covered agreement apply to insurers domiciled in the U.S. or the EU, respectively, that satisfy the following requirements:

- Financial requirements
  - In the case of U.S. reinsurers, maintain minimum capital and surplus of $250 million and a minimum authorized control level risk-based capital ratio of 300 percent (which translates to a 150 percent company action level risk-based capital ratio).
  - In the case of EU reinsurers, maintain minimum capital and surplus of €226 million and a minimum Solvency II solvency capital ratio (SCR) of 100 percent.
  - In contrast to the requirements for certified reinsurer status in the United States, there is no minimum credit rating requirement. The covered agreement does not specify whether permitted (as opposed to prescribed) accounting practices can be taken into account for purposes of the foregoing calculations.
- Notification requirements. Maintain good communications with the host jurisdiction's supervisory authority, including (i) giving notice of certain material events, (ii) delivering financial statements, actuarial opinions and related materials and (iii) submitting semi-annual lists of disputed and overdue (by 90 days or more) reinsurance claims from ceding insurers domiciled in the host jurisdiction.
- Submission to jurisdiction. Submit to the jurisdiction of, and agree to respect the judgments of, the host jurisdiction's court system, including with respect to the enforcement of arbitration awards.
- Additionally, a reinsurer must appoint the host supervisory authority as its agent for service of process. Each reinsurance agreement must also provide that the reinsurer will post collateral for 100 percent of its liabilities thereunder if it resists enforcement of a final judgment awarded to the ceding insurer.
- Prompt claims settlement. Demonstrate that it settles reinsurance claims promptly. Information regarding its assumed and ceded business and claims experience must be provided to the

supervisory authority of the host jurisdiction in support of the reinsurer's claims practices. Any of the following will cause the assuming reinsurer to fail this test:
    - more than 15 percent overdue or disputed reinsurance claims;
    - more than 15 percent overdue (by at least 90 days) undisputed claims in excess of $100,000 or €90,400 per ceding insurer; or
    - overdue (by at least 90 days) undisputed claims in excess of $50 million or €45.2 million in the aggregate.
- No solvent scheme of arrangement.
    - Confirm that it is not participating in any solvent scheme of arrangement involving ceding insurers in the host jurisdiction at the time of entry into a reinsurance agreement, and agree to post 100 percent collateral if the reinsurer enters into such an arrangement. Additionally, a ceding insurer subject to resolution, receivership or liquidation proceedings may seek an order from the court administering such proceedings, requiring the reinsurer to post collateral for all outstanding ceded liabilities.

Furthermore, a supervisory authority in a host jurisdiction must notify the reinsurer and its supervisory authority if it makes a determination that the reinsurer no longer satisfies the above conditions, and must generally provide the reinsurer with 30 days to submit, and 90 days to execute, a compliance plan to remedy the defect or deficiency before imposing collateral requirements or local presence requirements. A final decision to impose collateral requirements or local presence requirements as a consequence of a failure to remedy must be explained to the reinsurer in writing.

With the execution of the covered agreement, the clock begins ticking for U.S. state legislators and regulators to change their credit for reinsurance laws to eliminate requirements that EU reinsurers hold collateral against the U.S. risks they have reinsured. Indeed, the covered agreement calls for the U.S. states to reduce collateral requirements for EU reinsurers by 20 percent each year over the next five years. Accordingly, the policy statement by the Trump administration that was released upon the signing of the covered agreement encouraged each U.S. state to promptly adopt relevant credit for reinsurance laws and regulations consistent with the covered agreement's provisions on reinsurance collateral and to phase out the amount of collateral required to allow full credit for reinsurance for cessions to EU reinsurers.

For the states that have recently adopted laws allowing for collateral reduction by certified reinsurers, those states may not need to make significant changes to their laws in order to be compliant with the covered agreement (and presumably the existing certified reinsurer provisions would continue to apply to non-EU reinsurers). However, the states that have not adopted the certified reinsurer provisions will need to undertake significant revisions to their laws in order to conform with the covered agreement's requirements. Given that the covered agreement calls for the U.S. to begin deliberations on the federal preemption of state insurance laws that are inconsistent with the covered agreement by July 2020, which determination must be completed within 18 months after deliberations begin, it is likely that the NAIC's reinsurance task force will soon begin the process of adopting new amendment language for the model credit for reinsurance law and regulation for consideration by the states.

The covered agreement will have ripple effects beyond U.S.-EU reinsurance. Reinsurers in commercial centers outside of the EU, such as Bermuda, Japan and Switzerland, have already sought to level the playing field by urging the NAIC at the August 2017 Reinsurance Task Force meeting to make any proposed changes to the model credit for reinsurance law and regulation apply to not only EU reinsurers, but also to certified reinsurers domiciled in jurisdictions deemed to be qualified jurisdiction by the NAIC; some of these reinsurers may also decide to establish operations in the EU, or shift capacity there, in order to benefit from the covered agreement. Banks that work with EU reinsurers to provide letters of credit to U.S. ceding insurers will also be affected to the extent demand for the product decreases; the same will be true for trustees of credit for reinsurance trust accounts.

It is important to note that the required changes in state laws may take up to five years to implement, and, once implemented, those changes will only apply to prospective transactions. As a consequence, reinsurers with collateral arrangements already in force will need to maintain those arrangements going forward. Moreover, the covered agreement specifically contemplates that reinsurers and ceding insurers will have the ability to privately negotiate the collateral requirements that the parties deem appropriate, in keeping with the increased use of “comfort trusts” and similar arrangements in the wake of the financial crisis to mitigate credit exposure to reinsurers. So, while credit for reinsurance trusts and letters of credit may no longer be required by law in many circumstances once the provisions of the covered agreement are fully implemented, ceding insurers will still be able to request that EU reinsurers provide collateral protection, though such requests will now need to be resolved through commercial negotiations, rather than through deference to regulatory requirements.

David W. Alberts, Lawrence R. Hamilton and Francis R. Monaco are partners with Mayer Brown LLP. Jay A. Kallas is of counsel.