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Reinsurance Collateral Requirements – They Are A-Changing: An Update on the Covered Agreement Prior to the NAIC Fall Meeting

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In mid-November, the National Association of Insurance Commissioners (the "**NAIC**") will be holding its fall meeting, bringing together insurance regulators, companies and stakeholders to discuss issues facing the insurance industry today (the "**Fall Meeting**"). One of the most important topics under discussion at this meeting will be changes to the current regulatory regime governing the amount of collateral required to be posted by non-U.S. reinsurers.

On September 22, 2017, a covered agreement was signed between the U.S. Department of the Treasury, the Office of the U.S. Trade Representative and the European Union (the "**EU**") which requires a revised regulatory regime for such collateral requirements to be implemented within five years (the "**Covered Agreement**"). In response to the signing of the Covered Agreement, the NAIC's Reinsurance Task Force (E) has proposed amendments to the NAIC's credit for reinsurance model law and model regulation (the "**Proposed Amendments**") to facilitate the implementation of the Covered Agreement at the state level.[2]

Depending on the actions the NAIC takes at the Fall Meeting on the Proposed Amendments, the Fall Meeting could represent a turning point for the operation of non-U.S. reinsurers in the U.S.

Accordingly, in anticipation of the Fall Meeting, set forth below is a summary of the current regulatory regime for collateral posting requirements for non-U.S. reinsurers, a description of the Covered Agreement itself and an overview of the current status of the Proposed Amendments.

Regulatory Regime Prior to the Covered Agreement

In contrast to direct insurance, where an insurer generally needs to be licensed in a state in order to do business in the state, a reinsurer does not need to be licensed in a state in order to provide reinsurance to insurers in the state. However, if the reinsurer is not licensed in the state, then it historically has needed to collateralize its reinsurance obligations in order for the insurer purchasing the reinsurance (called the "ceding insurer") to take credit for the reinsurance on its balance sheet. As reinsurers are providing backing to the insurers that are directly protecting American policyholders, requiring them to maintain collateral in the U.S. is intended to ensure that claims-paying resources are available and accessible to U.S. ceding insurers and regulators should it be needed, particularly in the wake of a natural disaster.

In 2011, the NAIC passed amendments to its Credit for Reinsurance Model Law ("Model #785") and Credit for Reinsurance Model Regulation ("Model #786", together with Model #785, the "NAIC Models"). In states that have amended their laws and regulations to adopt these amendments, non-U.S. reinsurers that have completed a prescribed certification process can post significantly less than 100% collateral to secure their U.S. reinsurance obligations. To date, 48 states have passed legislation to implement the revised NAIC Models, which will become a requirement for NAIC accreditation as of January 1, 2019.3

Under the revised NAIC Models, individual reinsurers are certified based on criteria that include, but are not limited to, financial strength, timely claims, payment history and the requirement that a reinsurer be domiciled and licensed in a "qualified jurisdiction." The NAIC has established a comprehensive process to evaluate jurisdictions' oversight of reinsurers to designate five "qualified jurisdictions" for this purpose. Currently, Bermuda, France, Germany, Japan, Ireland, Switzerland, and the U.K., among others, have been so designated. The NAIC has also established a peer review system to oversee the certification of non-U.S. reinsurers by states, which enables non-U.S. reinsurers that become certified in one state to "passport" that certification throughout the U.S.

The Covered Agreement

Dodd-Frank established the legal framework for the United States to enter into bilateral or multilateral "covered agreements" with foreign jurisdictions that addresses regulatory measures with respect to the business of insurance or reinsurance. If state laws are inconsistent with a covered agreement and provide less favorable treatment to non-U.S. insurers or reinsurers than U.S. companies, then the covered agreement will preempt state law. A covered agreement can serve as a basis for preemption of state law only if the agreement relates to measures substantially equivalent to the protections afforded consumers under state law.

The Covered Agreement that was signed on September 22, 2017 requires U.S. states to eliminate reinsurance collateral requirements for EU reinsurers that satisfy certain stipulated qualifications within 5 years or else the preemption provisions of Dodd-Frank will potentially come into effect. In exchange, the EU will not impose local presence requirements on U.S. firms operating in the EU, and effectively must defer to U.S. group capital regulation for U.S. entities of EU-based firms.

Following the signing of the Covered Agreement, the NAIC held, on February 20, 2018, a public hearing to address issues relating to the implementation of these reinsurance collateral reform provisions. Among the issues raised were how implementation of the Covered Agreement would interface with the certified reinsurer regime that the NAIC had already put in place and whether reinsurers from "qualified jurisdictions" outside the EU would be granted benefits similar to those in the Covered Agreement. The Proposed Amendments address both of these issues, among others.

Comment letters on the Proposed Amendments have reflected a number of common issues raised by interested parties including: (i) concerns regarding the degree of discretion of individual state insurance regulators (including with respect to the ability to request additional information not required under the Covered Agreement) and resulting disparate treatment of non-EU jurisdictions; and (ii) the need for greater conformity in the language of the Proposed Amendments to the language in the Covered Agreement.

Current State of Proposed Amendments

The Proposed Amendments, in their current form, would allow a U.S. ceding insurer to take 100% credit for reinsurance for transactions with non-U.S. reinsurers that meet all of the following requirements:

1. The assuming reinsurer has its head office, or is domiciled, in a "reciprocal jurisdiction." A "reciprocal jurisdiction" includes: (i) any non-U.S. jurisdiction that has entered into a treaty or international agreement with the U.S. regarding credit for reinsurance; and (ii) any "qualified jurisdiction" (for certified reinsurer purposes) that is not a party to such an agreement with the U.S. and that satisfies requirements comparable to those imposed by the Covered Agreement with respect to the treatment of U.S. reinsurers operating in such jurisdiction;
2. The assuming reinsurer maintains minimum capital and surplus (or its equivalent) of not less than $250 million;
3. The assuming reinsurer maintains a prescribed minimum solvency or capital ratio; and
4. The assuming reinsurer agrees to be subject to U.S. jurisdiction for certain limited purposes and to make certain informational filings with state insurance regulators.

Next Steps for Implementation of the Covered Agreement

The Proposed Amendments, if adopted, will revise the NAIC Model to comply with the Covered Agreement. That means that states that have already adopted the NAIC Models could simply adopt those revisions in order to implement the Covered Agreement.

However, while the majority of the states have adopted versions of the NAIC Model, a small number of states have not adopted any version of either Model #785 or Model #786, some have adopted outdated versions and some have or are in the process of making unique modifications to the versions of the NAIC Models which they have adopted. It is unclear whether the prospect of preemption will be sufficient incentive for states to adopt the revised versions of the NAIC Models or for them to take other equivalent actions to bring their laws into conformity with the Covered Agreement. And given the time required for new legislation to be introduced, deliberated on and passed by the state legislatures, there is realistically not a lot of time left for the states to act.

The latest version of the Proposed Amendments has yet to be circulated by the NAIC Reinsurance (E) Task Force; accordingly, the likely reaction of state insurance regulators to the Proposed Amendments at the Fall Meeting is difficult to predict. Nevertheless, the overall path to implementation of the Covered Agreement will be determined at the Fall Meeting – and with it, state insurance regulators will reveal their willingness to risk preemption of their current regulatory frameworks if they remain unpersuaded that the revised Proposed Amendments do not sufficiently address their concerns. Consequently, the outcome of the Fall Meeting could cause reverberations in the insurance industry beyond the arena of collateral posting requirements for non-U.S. reinsurers and reach into the intersection of authority between state insurance regulators and the federal government.

Endnotes

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[2] Additionally, the Federal Insurance Office (the "**FIO**") has recently initiated efforts to achieve a U.S.-UK covered agreement by the March 29, 2018 "hard Brexit" deadline. The purpose of this effort is to ensure that there is no disruption in the current U.S. insurer activities in the UK once the UK is formally no longer an EU member. Given the rapidly approaching date for Brexit, and the required 90-day Congressional review period before a final covered agreement can be effective in the U.S., the FIO is aiming to have a final negotiated agreement by mid-December of this year.

[3] In 2016, the NAIC adopted changes to Model #785 with respect to captive reinsurance transactions, specifically with respect to XXX/AXXX life reinsurance transactions. At this time, 22 states have taken action to adopt the 2016 revisions to Model #785 in some form.