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U.S. to Sign the EU-U.S. Covered Agreement (Bilateral Covered Agreement)

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In a two-paragraph statement released on Friday, July 14, the Trump administration agreed to proceed with finalizing the Bilateral Covered Agreement between the United States and the European Union ("Covered Agreement"), which will start a five-year process to reduce reinsurance collateral to zero. The U.S. statement emphasized the prospective advantages and growth opportunities in the EU for U.S. re/insurers:

"The U.S. Department of the Treasury and the Office of the U.S. Trade Representative today announced their intent to sign the Bilateral Agreement between the United States of America and the European Union on Prudential Measures Regarding Insurance and Reinsurance. In addition to signing the Agreement in the coming weeks, the Administration also plans to issue a U.S. policy statement on implementation.

This is an important step in making U.S. companies more competitive in domestic and foreign markets and making regulations efficient, effective and appropriately tailored. Furthermore, the Bilateral Agreement benefits the U.S. economy and consumers by affirming America's state-based system of insurance regulation, providing regulatory certainty, and increasing growth opportunities for U.S. insurers."

Contrary to the platitudes in the press release — e.g., the Covered Agreement provides "regulatory certainty" and "affirms America's state-based system of insurance regulation" — the agreement really does neither with respect to U.S. credit for reinsurance regulation.

New Uncertainties

Questions arise immediately about how various interested parties — U.S. cedents, U.S. state regulators, non-U.S. owners of U.S. re/insurers — will react to the new era of reinsurance regulation. Will U.S. state regulators who believe that policyholder protection is imperiled by a looming era of zero collateral take action to impose new capital requirements on U.S. cedents? How will this agreement be implemented by U.S. state regulators and how will reinsurers in Bermuda, Switzerland and the United Kingdom be affected by the advantages provided to EU-based reinsurers? How will the regulatory changes impact the current reinsurance market, which is characterized by the softest conditions in a generation?

Next Steps

It is worth stressing that for EU-based reinsurers, even those that meet all the financial, solvency and market conduct requirements set forth in the Covered Agreement, NOTHING happens immediately. The Covered Agreement is not self-executing – state legislative changes to step down reinsurance collateral from 100 percent to zero for qualifying reinsurers will be required. How those changes will be implemented is not entirely clear. U.S. state regulators and legislatures may change existing law to apply to all reinsurance transactions (i.e., not limit the changes to EU-based reinsurers), or they may opt for more restricted changes. Further, the agreement does not prohibit U.S. regulators from imposing additional capital or other requirements, as long as those requirements are applied equally to all reinsurance transactions.

If state regulators take no action to implement the Covered Agreement, under the Dodd-Frank Act the federal government can preempt state law that is not consistent with the requirements of the Covered Agreement. U.S. federal authorities (Federal Insurance Office, or FIO), however, may not "begin evaluating a potential preemption determination" until 42 months after January 13, 2017, and then may only take action if a state is treating an EU reinsurer less favorably than U.S. licensed reinsurers. FIO is also required to prioritize its enforcement actions to focus on action (or inaction) by states based on ceded reinsurance premiums and must complete the "necessary preemption determination" within 60 months after January 13, 2017. The procedural process set forth in the Dodd-Frank Act will make this determination a difficult undertaking, and what happens after that determination is less than clear.

Presumably EU re/insurers with U.S. affiliates will focus on changing the credit for reinsurance laws in the state(s) in which their U.S. affiliates are domiciled to lower required collateral to zero (in advance of the five-year deadline in the Agreement if at all possible). Most state legislatures have adjourned for the year, so this will be a 2018 project at the earliest (except in Texas, where the legislature will not convene in 2018). In reality, the National Association of Insurance Commissioners (NAIC) will first need to evaluate what changes are required by the Covered Agreement, develop procedures to implement those changes, and consider whether other regulatory changes are needed to address issues not addressed by the Covered Agreement before any legislation will be considered by individual states. So it is fairly unlikely that any legislation will be considered in 2018.

Practical Response by the Marketplace

Beyond the five-year runway noted above, Article 3, Paragraph 7, of the Covered Agreement makes it very clear that "nothing in the [Covered Agreement] shall limit or in any way alter the capacity of parties to a reinsurance agreement to agree on requirements for collateral or other terms in that reinsurance agreement." Like the NAIC's certified reinsurer construct, the Covered Agreement framework preserves the ultimate influence of marketplace dynamics with respect to collateral. Pretty obviously, in the current soft market environment, perhaps the least favorable for reinsurers in a generation, collateral requirements will likely remain at or near 100 percent for unaffiliated transactions. Transactions between affiliates, however, are more likely to result in collateral reductions once the authorizing language is implemented.

State Regulator Actions to Implement the Covered Agreement

It is unclear what action, if any, state regulators will take in reaction to the Covered Agreement. Although the Treasury’s announcement acknowledges the primacy of state-based regulation, the Covered Agreement requires significant changes to state-based credit for reinsurance regulation for EU-based reinsurance. Federal law under the Dodd-Frank Act provides that states must take action consistent with the requirements of the Covered Agreement or face the possibility that the federal government may take action to preempt state law to the extent it is inconsistent with the Covered Agreement.

There are state regulators (and cedents) who continue to believe that reduced collateral is a negative, from both a financial solvency and a consumer protection perspective. The Covered Agreement does not prevent U.S. state regulators from imposing new requirements as long as those requirements are applied uniformly to all reinsurance transactions. As a result, it is possible that U.S. regulators will try an end-run around collateral requirements and instead focus on cedent balance sheets, risk-based capital charges and/or new minimum capital and surplus requirements. It is likely that the NAIC will provide some guidance on which direction it is considering at its upcoming National Meeting in Philadelphia early next month.

Now What?

The Covered Agreement is not really an end in itself – instead it signals the start of a new era in U.S. insurance regulation. It also raises the question of how reinsurers from jurisdictions outside the EU should be treated. Will government authorities in Bermuda, the UK (anticipating the need to address Brexit), Japan and Switzerland plunge ahead immediately with "me too"-type Covered Agreements? Will they do so without knowing first how state regulators are going to react? Will state regulators be inclined to implement legal changes to comply with the Covered Agreement in a way that will avoid the need for these other jurisdictions to seek their own bilateral agreements in order to minimize the role of the U.S. federal authorities? These are all issues that will be front and center while the NAIC decides what action it will take to respond to the Covered Agreement.