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The Future of the US-EU Covered Agreement: How to Drag an Absurdly Federalist Regulatory System into the Global Reinsurance Market

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Note

The Future of the US–EU Covered Agreement: How to Drag an Absurdly Federalist Regulatory System into the Global Reinsurance Marketplace

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The US–EU Covered Agreement ("Covered Agreement") is a bilateral agreement between the United States ("US") and the European Union ("EU") that puts in place regulations that will govern the insurance and reinsurance industries in those regions.[1] This agreement represents an early step towards what will likely become a more standardized and integrated approach to international regulation of insurance markets. This note will give the context and background necessary to understand the Covered Agreement, explain the main provisions of the Covered Agreement, analyze criticisms and next steps, and advocate for a specific implementation of the Covered Agreement.

Section One explains how reinsurance functions. Section Two is a discussion of traditional insurance market regulations in the US and the EU followed by a comparison of the two systems as they currently stand. Section Three gives a background on covered agreements generally and how they function. This section also introduces the key provisions of the US–EU Covered Agreement and possible implementations of the Covered Agreement. Finally, Section Four explores concerns raised about the Covered Agreement, counters those concerns, and provides a defense of the Covered Agreement as a beneficial step forward for the EU and especially the US. Despite the issues raised by some regulators and insurance companies, ultimately,

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1. Fact Sheet: Bilateral Agreement between the European Union and the United States of America on Prudential Measures Regarding Insurance and Reinsurance, U.S. DEP'T OF TREASURY (Jan. 13, 2017), https://www.treasury.gov/initiatives/fio/reports-and-notices/Documents/Covered-Agreement-Fact-Sheet-(011317)-FINAL.PDF.

the substance of the Covered Agreement is fair and positive for the US and should be implemented as soon as possible by the individual states.

I. REINSURANCE: BACKGROUND AND PURPOSE

The Covered Agreement mainly focuses on regulations for reinsurance. Reinsurance is insurance purchased by insurance companies (health, home, auto, life, disability, liability) against the risk of claims that the insurers must pay.[2] It is, essentially, insurance for insurance companies. It represents an important solvency management tool that almost all insurance companies use. There are specific reinsurance companies, but many general insurance companies have reinsurance departments and they all reinsure each other's claims.[3] The insurance company buying the reinsurance is known as the "cedent" or "ceding insurer."[4]

Reinsurance serves multiple purposes. First, it limits a cedent's risk and losses (the reason individuals buy insurance). The risk these companies are insuring against is that the premiums they charge policyholders will be less than the claims they must pay out on those policies.[5] Having reinsurance also increases the cedent's underwriting capacity.[6] Underwriting capacity is the "maximum amount of loss exposure insured by the insurer." [7] Insurers can cover higher risk or higher value policies when they know they have reinsurance protection. Reinsurance also promotes a more efficient allocation of an insurer's capital.[8] Much of an insurer's capital comes from the premiums they receive on policies. Insurers need to retain some of those funds in reserve accounts, set aside to pay out claims as

2. NAIC REINSURANCE TASK FORCE OF THE FINANCIAL CONDITION (E) COMMITTEE, U.S. REINSURANCE COLLATERAL WHITE PAPER 4 (Mar. 5, 2006) ("A ceding insurer transfers risk to an assuming reinsurer, the insurance company that assumes all or part of the risk of one or more insurance policies issued by the cedent.").

3. *See Top 50 Global Reinsurance Groups,* REINSURANCE NEWS, https://www.reinsurancene.ws/top-50-reinsurance-groups/.

4. *Cedent*, BLACK'S LAW DICTIONARY (10th ed. 2014).

5. FED. INS. OFF., U.S. DEP'T OF THE TREASURY, THE BREADTH AND SCOPE OF THE GLOBAL REINSURANCE MARKET AND THE CRITICAL ROLE SUCH MARKET PLAYS IN SUPPORTING INSURANCE IN THE UNITED STATES 1 (Dec. 2014).

6. *Id.*

7. *Underwriting*, BLACK'S LAW DICTIONARY (10th ed. 2014).

8. NAIC, *supra* note 2, at 5.

they arise.[9] With reinsurance protection, insurers have the flexibility to use more of the capital in the business instead of saving it to pay out claims. Reinsurance is most useful for risks with a low probability of occurrence, but a high cost if they do occur.[10]

II. INTRODUCTION TO TRADITIONAL INSURANCE REGULATION

This section outlines the historical development of insurance regulation in the US and EU systems as well as the main differences between the two regulatory systems.

A. THE EU SYSTEM

The primary regulatory framework in the EU for insurance and reinsurance is Solvency II.[11] It primarily regulates solvency, which, in the insurance sphere, is the ability of insurers to meet their claim obligations to policyholders.[12] Solvency II is a council directive that came into effect in 2009.[13] Before Solvency II, the EU insurance and reinsurance markets were governed by Solvency I, which was established in 1973.[14] Solvency II modernized insurance regulation by identifying additional risks that were not captured under Solvency I, and by making requirements more risk-sensitive. The Solvency II directive has three main pillars. The first is a system of risk-based capital requirements where insurance companies undergo risk profiles and are thus required to maintain specific capital requirements based on their determined level of risk.[15] The second pillar is market discipline, or governance and risk management requirements.[16] This provides for a transparent governance

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9. *Claims Reserve*, INVESTOPEDIA, https://www.investopedia.com/terms/c/claims-reserve.asp (last visited Sept. 27, 2018).

10. Examples of risks include natural disasters and other catastrophes. INT'L ASS'N OF INS. SUPERVISORS, REINSURANCE AND FINANCIAL STABILITY 19 (2012).

11. Council Directive 2009/138, art. 1, 2009 O.J. (L 335) (EC).

12. FED. INS. OFF., U.S. DEPARTMENT OF THE TREASURY, HOW TO MODERNIZE AND IMPROVE THE SYSTEM OF INSURANCE REGULATION IN THE UNITED STATES 23 (Dec. 2013).

13. Council Directive 2009/138, *supra* note 11, at 1.

14. Council Directive 73/239, art. 1, 1973 O.J. (EC).

15. Council Directive 2009/138, *supra* note 11, at 28.

16. *Id.* at 34.

system where insurance companies need to conduct regular "Own Risk Solvency Assessments" (ORSAs).[17] An ORSA is an internal process where insurers self-assess their risk management for all reasonably foreseeable risks (credit, market, liquidity, underwriting, etc.) and analyze their present and future solvency positions.[18] The elements of an ORSA analysis are: "(i) a description of the insurance or reinsurance group's risk management framework; (ii) an assessment of the insurance or reinsurance group's risk exposure; and (iii) a group assessment of risk capital and a prospective solvency assessment."[19] The third pillar of Solvency II is supervisory reporting and public disclosure. Companies must make reports to the supervisory authority body created in the Solvency II directive and make regular disclosures to the public.[20]

B. THE US SYSTEM

The US insurance regulatory scheme is unique in the international community. Insurance regulation in the US is left mainly to the states, which leads to multiple—sometimes conflicting—regulations, instead of one set of national regulations with one national supervisory enforcement body, which most countries have.[21] There exists some degree of uniformity because of standard-setting and oversight by the National Association of Insurance Commissioners (NAIC) but control remains firmly in the hands of the states.[22]

The origins of state insurance regulation are strongly shaped by two major cases and one important piece of legislation. In 1868, the Supreme Court decided, in *Paul v. Virginia*, that insurance is not commerce and therefore the federal government cannot regulate it through its commerce

17. *Id.*

18. *Own Risk Solvency Assessment*, NAIC CTR. FOR INS. POL'Y & RES. (Apr. 9, 2018), https://www.naic.org/cipr_topics/topic_own_risk_solvency_assessment.htm.

19. *Id.*

20. Council Directive 2009/138, *supra* note 11, at 36.

21. David Zaring, *It is time to Rethink Insurance Regulation*, N.Y. TIMES (Jan. 22, 2014), https://dealbook.nytimes.com/2014/01/22/it-is-time-to-rethink-insurance-regulation/ ("[T]he American system of insurance regulation, where the federal role is minimal and each state has a different regulatory regime.").

22. *See State Insurance Regulation*, NAIC CTR. FOR INS. POL'Y & RES. (2011), https://www.naic.org/documents/topics_white_paper_hist_ins_reg.pdf (explaining the function of the NAIC in state insurance regulation).

clause power.[23] The opinion stated that, "[i]ssuing a policy of insurance is not a transaction of commerce."[24] The reasoning was that insurance policies are essentially local, personal contracts of indemnity and are not interstate transactions, even if the parties are in different states.[25] It was not until 1944 that the Supreme Court reversed this decision in the South Eastern Underwriters Association (SEUA) case, and decided that insurance *is* commerce that can be regulated by Congress.[26] The Supreme Court stated that even though insurance contracts themselves are local in nature, they create a chain of events that becomes interstate commerce.[27] In reaction to the SEUA case, Congress passed the McCarran-Ferguson Act in 1945. "Several Congressmen had reacted to the South-Eastern Underwriters litigation . . . these congressman introduced legislation that would have completely exempted the insurance industry from antitrust laws . . . Senators McCarran and Ferguson introduced an amended version of this proposal."[28] This Act contains a reverse preemption clause, which states that "[n]o Act of Congress shall be construed to invalidate, impair or supersede any law enacted by any State for the purpose of regulating the business of insurance."[29] This provision ensures that federal laws that do not expressly regulate the "business of insurance" will not preempt state insurance laws.[30] Another major piece of legislation which affects insurance regulation in the US is the Dodd-Frank Act. Dodd-Frank created the Federal Insurance Office (FIO) within the Department of the Treasury.[31] The FIO was created to "monitor all aspects of the insurance industry, including identifying issues or gaps in the regulation

23. Paul v. Virginia, 75 U.S. 168 (1868).

24. *Id.* at 183.

25. *Id.*

26. United States v. S.E. Underwriters Ass'n, 322 U.S. 533 (1944).

27. *Id.* at 547.

28. Alan M. Anderson, *Insurance and Antitrust Law: The McCarran-Ferguson Act and Beyond*, 25 WM. & MARY L. REV. 1, 85–86 (1983).

29. McCarran-Ferguson Act, 15 U.S.C, §§ 1011–1015 (1945).

30. *See* Anderson, *supra* note 28, at 90 ("[The] three-prong test for determining whether an insurer's activity is within the business of insurance: the first prong examines whether the activity involves the underwriting or spreading of risk; the second prong focuses on whether the activity involves the insurer-insured relationship; and the third prong, as refined in *Pireno,* asks whether the activity is limited to entities within the insurance industry, thus conforming to the legislative intent of the Act.").

31. Dodd-Frank Wall Street Reform and Consumer Protection Act, H.R. 4173; P.L. 111–203 (2010) ("Dodd-Frank").

of insurers that could contribute to a systemic crisis in the insurance industry or the US financial system."[32] Importantly, this body monitors but does not regulate.[33] The FIO does not have the power to enforce regulations on insurance companies apart from requiring disclosure and access for the purpose of monitoring.[34]

State solvency regulation is largely coordinated by the NAIC.[35] This group of state insurance commissioners creates model laws and regulations that state legislatures can choose to adopt.[36] These model rules pertain to all aspects of insurance regulation, but the most widely adopted are the solvency rules, which are almost unanimously codified by the states.[37] These solvency rules are so widely adopted because of the NAIC's regulation equivalency system for solvency regulation.[38] States that participate in the program and adopt the NAIC's model solvency laws only need to be regulated by their home state authority, and do not need to be regulated by every state they do business in because the participating states' insurance regulatory programs are considered to be equivalent.[39] Like Solvency II in the EU, the NAIC solvency regulations require insurers to perform regular ORSA's to self-analyze their solvency and risk levels.[40]

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32. *Id.* § 313.

33. *Federal Insurance Office (FIO)*, NAIC CTR. FOR INS. POL'Y & RES. (July 13, 2018), https://www.naic.org/cipr_topics/topic_fio.htm ("FIO does not have supervisory or regulatory authority over the business of insurance.").

34. *See About FIO*, U.S. DEP'T TREASURY (JUNE 12, 2013), treasury.gov/initiatives/fio/about-fio ("In addition to advising the Secretary of the Treasury [] on major domestic and prudential international insurance policy . . . FIO is specifically authorized to: monitor all aspects of the insurance industry, including identifying issues or gaps in the regulation of insurers that could contribute to a systemic crisis in the insurance industry or the U.S. financial system.").

35. *See About the NAIC*, NAIC CTR. FOR INS. POL'Y & RES., https://www.naic.org/index_about.htm (last visited Sept. 25, 2018) (describing the functions of the NAIC).

36. *See id.*

37. *Id.*

38. *See State Insurance Regulation*, *supra* note 22, at 5 (explaining the NAIC's solvency equivalency system); NAIC MODEL LAWS, REGULATIONS AND GUIDELINES § III-390 (1999) at 3.

39. *See* NAIC MODEL LAWS § III-390, *supra* note 38.

40. NAIC MODEL LAWS, REGULATIONS AND GUIDELINES § III-505 2012).

C. COMPARISON OF THE US AND EU INSURANCE REGULATORY SYSTEMS

The main difference between EU and US insurance regulation is that in the US there is relatively little regulation of insurance on the national level. Most regulation is done by the states, which can lead to international insurers following multiple regulations if they wish to operate in the US.[41] Another challenge for the US is that it brings so many people to the international insurance negotiating table. State insurance regulators want to be present because they are the ones that make the regulations.[42] The NAIC wants to be included as a representative of the states.[43] The leaders of FIO also want to be present as the national insurance supervisors.[44] These competing interests can make international negotiations more difficult.

Both the EU and the US have implemented ORSA procedures and graduated capital requirements where companies evaluated to have higher risk levels are required to hold more capital to ensure that they can adequately pay their claims.[45]

III. INTRODUCTION TO THE US–EU COVERED AGREEMENT

A. COVERED AGREEMENTS GENERALLY

The notion of a covered agreement was first included in Dodd-Frank.[46] It creates the authority for the Treasury Department and the US Trade Representative (USTR) to

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41. *See Fact Sheet: Bilateral Agreement between the European Union and the United States of America on Prudential Measures Regarding Insurance and Reinsurance*, *supra* note 1 ("In the United States, state insurance regulators have general authority over the business of insurance (including reinsurance)").

42. *See State Insurance Regulation*, *supra* note 22, at 2 ("State legislatures are the public policymakers that establish set broad policy for the regulation of insurance").

43. *See About the NAIC*, supra note 35.

44. *See About FIO*, supra note 34.

45. Council Directive 2009/138, *supra* note 11; OWN RISK AND SOLVENCY ASSESSMENT (ORSA) (E) SUBGROUP OF THE FINANCIAL CONDITION (E) COMMITTEE, NAIC OWN RISK AND SOLVENCY ASSESSMENT (ORSA) GUIDANCE MANUAL (July 2014).

46. Dodd-Frank, *supra* note 31 at §531

address areas where state insurance laws treat US insurers differently than non-US insurers.[47]

1. The Process for Entering into a Covered Agreement

The USTR and FIO negotiate the covered agreement jointly.[48] Throughout the process they consult several congressional committees and update the committees on the nature of the agreement, how it will achieve the purpose of the Dodd-Frank Act, and how the eventual implementation of the covered agreement will affect state laws.[49] Before the agreement can go into effect it must be submitted to the House Financial Services Committee, House Ways and Means Committee, the Senate Banking Committee, and the Senate Finance Committee.[50] There is then a ninety-day waiting period after which the agreement can enter into force.[51]

2. Covered Agreement Preemption

Under Dodd-Frank, covered agreements "can serve as a basis for preemption of a state law under certain circumstances if the agreement relates to measures substantially equivalent to the protections afforded consumers under state law."[52] This means current state laws that have collateral requirements for EU reinsurance companies could be invalidated if the FIO Director determines that they are inconsistent with the Covered Agreement.[53] A covered agreement will serve to overcome the reverse preemption clause in the McCarran-Ferguson Act, requiring that the states follow the rules of the Covered Agreement as long as those rules afford consumers the same protections they would get under state law.[54]

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47. *Key Issue: The National System of State Regulation and Covered Agreement*, NAIC CTR. FOR INS. POL'Y & RES. (July. 10, 2018), https://www.naic.org/cipr_topics/topic_covered_agreement.htm.

48. *Id.*

49. NAIC GOV'T REL., COVERED AGREEMENT ON REINSURANCE CONSUMER PROTECTION COLLATERAL at 2 (2016).

50. *Id.*

51. *Id.*

52. *Id.*

53. *Id.* at 2 (describing the effects of the Covered Agreement on the states).

54. *Id.*

B. KEY PROVISIONS OF THE COVERED AGREEMENT

The US–EU Covered Agreement has three main focuses for international prudential insurance regulation: reinsurance, group supervision, and free exchange of information between insurance supervisors.[55]

1. Reinsurance

The Covered Agreement provisions related to reinsurance are centered on the elimination of capital requirements that the US currently imposes on EU reinsurers.[56] Foreign reinsurance companies that operated in the US historically were required to hold 100% collateral for risks assumed from US insurers.[57] This was done to make sure the reinsurance companies had enough capital to pay any claims that arose. Because of the way reinsurance works, the occasions when reinsurance companies have to pay out claims tend to be less predictable, large-scale events, like natural disasters. Therefore, it is especially important for reinsurance companies to be sufficiently capitalized to pay claims.[58] However, a 100% collateral requirement forces reinsurance companies to hold a substantial amount of capital on their books that is unavailable for investing or other purposes.[59]

Under the US–EU Covered Agreement, US and EU regulatory bodies can no longer hold collateral requirements, or other requirements with the same effect. Neither party is allowed to

> (a) maintain or adopt any requirement to post collateral in connection with cessions from a Host Party Ceding Insurer to a Home Party Assuming Reinsurer and any related reporting requirement attributable to such

55. Bilateral Agreement Between the United States of America and the European Union on Prudential Measures Regarding Insurance and Reinsurance, art. 5–8, Eur. Union-U.S., Sept. 22, 2017, T.I.A.S. 18-0404 [hereinafter US-EU Covered Agreement].

56. *Fact Sheet: Bilateral Agreement between the European Union and the United States of America on Prudential Measures Regarding Insurance and Reinsurance*, *supra* note 1.

57. NAIC GOV'T REL., *supra* note 49, at 1.

58. *Id.*

59. *Id.*

> removed collateral, or (b) maintain or adopt any new requirement with substantially the same regulatory impact on the Home Party Assuming Reinsurer as collateral requirements removed under this Agreement or any reporting requirement attributable to such removed collateral.[60]

Because ending collateral requirements removes a level of assurance that claims will be paid, the Covered Agreement implements new group supervision requirements. The idea is that if the solvency regulation is accurate, consumers will know that reinsurance companies are able to pay out their claims, so there will be no need for high collateral requirements.

2. Group Supervision

Under the group supervision provisions, US insurers are relieved from following the requirements of Solvency II and its corresponding supervisory authorities as long as the US follows group capital assessment requirements, which capture the risk of parent companies instead of their individual subsidiary entities.[61] As defined in the Covered Agreement, group supervision means "the application of regulatory and prudential oversight by a supervisory authority to an insurance or reinsurance group for purposes including protecting policyholders and other consumers, and promoting financial stability and global engagement."[62] Essentially group supervision is the idea that insurance companies need to be monitored at the "group" or parent-company level rather than monitoring the individual subsidiaries of the insurance or reinsurance company as separate entities.[63]

Another important provision of Article Four on group supervision is the idea of Home supervisory authorities versus Host supervisory authorities.[64] Before the Covered Agreement took place, an insurer that had branches in the US and the EU

60. US–EU Covered Agreement, *supra* note 55, at 4.
61. *See id.* (detailing group supervision requirements).
62. *Id.* at 6.
63. Daniel Schwarcz, *A Critical Take on Group Regulation of Insurers in the United States*, 5 U.C. IRVINE L. REV. 537, 541 (2015).
64. *See* US–EU Covered Agreement, *supra* note 55, at 18 (describing the new Home/Host supervisory requirements).

would be regulated by both the US and the EU.[65] The regulations varied and the supervisory authorities in each jurisdiction had different procedures and requested different documents.[66] Under the Covered Agreement, a US company with branches in the EU will only need to be regulated by the US, and an EU company with branches in the US will only need to be regulated by the EU. So, insurance companies will only need to report to the supervisory authority in their Home country and not in the Host country of their subsidiary. This is essentially a large-scale version of the NAIC's state solvency equivalency program where insurance companies only need to be regulated in their home states because all the states are operating under the same regulations.[67]

However, allowing insurance companies to report solely to their Home authority only works if the regulatory schemes of the US and the EU are deemed to be equivalent.[68] While the Covered Agreement does reference using "equivalent documentation" under the group supervision requirements, the Covered Agreement does not explicitly state that the regulatory schemes are actually equivalent.[69] Currently under Solvency II, EU insurance regulation is done at the group level.[70] The US ostensibly started monitoring on the group level in 1969, but the weaknesses in their approach were made apparent after the 2007–2008 financial crisis.[71] The US approach to monitoring and supervision has been described as a "windows and walls" system.[72] There are walls between the insurance subsidiaries of a large parent company to protect the individual insurer's capital, but there are windows in those protective walls so

65. Eur. Ins. & Occupational Pensions Auth., *Guidelines on the supervision of branches of third-country insurance undertakings*, EIOPA-BoS-15/110 (Oct. 23, 2010).

66. *Id.*

67. *Id.*

68. *Id.*

69. *See* US-EU Covered Agreement, *supra* note 55, at 19 ("Where no such worldwide group ORSA is applied to a Home Party insurance or reinsurance group, according to applicable law, the relevant US State or EU Member State's supervisory authority provides equivalent documentation which is prepared consistent with applicable law of the Home supervisory authority . . . .").

70. Council Directive 2009/138, *supra* note 11.

71. Kris DeFrain, *Insurance Group Supervision*, NAIC CTR. FOR INS. POL'Y & RES. (Apr. 2012), https://www.naic.org/cipr_newsletter_archive/vol3_ins_group_supervision.htm.

72. *Id.*

insurance regulators can monitor the group as a whole.[73] In the years leading up to 2007, the windows at American International Group, Inc. ("AIG") must have been dirtied because regulators were slow to see the danger in AIG's tangled subsidiaries. Problems arose because "AIG Investments loaned securities from the investment portfolios of AIG's insurance companies to various financial institutions in exchange for cash collateral posted by the borrower. AIG Investments would then invest the collateral in debt securities to earn a return which would serve as compensation for lending securities."[74]

Because of this failure, the NAIC amended Model Laws #440 and #450.[75] The new model laws give state regulators expanded ability to monitor holding companies that pose a risk to the insurance branch of that company.[76] They also give regulators greater access to the records of the parent company.[77] The US has made strides towards more comprehensive group supervision. Most states have adopted at least part of the Insurance Holding Company model regulation.[78] But in order to eventually be considered equivalent the US must develop a "Worldwide Group Capital Calculation."[79] A worldwide group capital calculation needs to capture the risk level of the entire group, which includes the parent undertaking of the insurance or reinsurance company.[80] This risk analysis system emphasizes monitoring all subsidiaries and arms of a group in every country that they operate in in order to get a more accurate picture of their true risk profile.[81] After the Covered Agreement was signed, the NAIC formed a Group Capital Calculation working group to develop their own group capital methodology.[82] The working group met with the Federal Reserve Board on February 12th, 2018 to discuss the construction of this calculation.[83]

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73. *Id.*
74. William K. Sjostrom, Jr., *The AIG Bailout*, 66 WASH. & LEE L. REV. 943, 961 (2009).
75. DeFrain*, supra* note 71.
76. *Id.*
77. NAIC MODEL LAWS, REGULATIONS AND GUIDELINES § III-450 (2011).
78. *Id.*
79. *See* US–EU Covered Agreement *supra* note 55, at 21 (describing the worldwide group capital calculation).
80. *Id.* at 19.
81. *See id.* at 8 (explaining the new risk analysis system).
82. *Group Capital Calculation (E) Working Group*, NAIC, https://www.naic.org/cmte _e_grp_capital_wg.htm (last visited Sept. 17, 2018).
83. *Id.*

3. Open Exchange of Information

The goal for the open exchange of information between insurance supervisors is a non-binding encouragement for insurance supervisors in the US and EU to share information. The Covered Agreement includes model provisions for information exchange that the insurance supervisors are encouraged to adopt.[84] Article Five of the Covered Agreement is more of a brief goal statement than the other two clear directives in the Covered Agreement: The Parties shall encourage supervisory authorities in their respective jurisdictions to cooperate in exchanging information pursuant to the practices set forth in the Annex. The Parties understand that the use of such practices will enhance cooperation and information sharing, while respecting a high standard of confidentiality protection.[85] More specific information exchange practices will likely be developed as the US and the EU begin the process of implementing the rest of the Covered Agreement.

C. Implementation of the Key Provisions

EU member states have twenty-four months from the signing of the Covered Agreement to eliminate local presence requirements and US companies that have not yet established branches in the EU do not have to do so.[86] The US needs to start a preemption determination under Dodd-Frank within forty-two months of the signing of the Covered Agreement (and complete it within sixty months of signing) to find out whether the Covered Agreement preempts the laws of any states by treating EU insurers less favorably than US insurers.[87] Because the individual states regulate collateral requirements, each state will need to individually decrease their current collateral requirements. Collateral requirements for EU reinsurers need to be decreased by at least 20% each year until the collateral holding requirement reaches 0%.[88]

Group supervision implementation will start with a sixty-

84. *See About FIO, supra* note 1 (discussing the new model provisions).
85. US–EU Covered Agreement, *supra* note 55, at 24.
86. *EU/U.S. Covered Agreement: What's Next?*, HOGAN LOVELLS 9 (Feb. 2017), hlinsurancelaw.com/files/2017/02/EU-US-Covered-Agreement-What-Next.pdf.
87. US–EU Covered Agreement, *supra* note 55, at 29.
88. *Id.* at 28.

month period where EU supervisory authorities will not impose worldwide group capital requirements on the US [89] Currently, US regulations do not comply with worldwide group capital calculations.[90] During that period, the US is to "provisionally apply" those requirements using "best efforts" and "encouraging" the insurance regulation authorities of the individual states to follow the requirements.[91]

IV. LOOKING AHEAD: POTENTIAL PROBLEMS AND WHY THE COVERED AGREEMENT IS POSITIVE DESPITE TED NICKEL'S OBJECTIONS

A. FUTURE PLANS

The Covered Agreement was signed in September 2017 and the US and the EU are both in the process of determining the best way to implement it.[92] The NAIC is currently going through a notice and comment period, and they held a meeting of the newly created Reinsurance Task Force on February 20, 2018 to discuss potential implementations.[93] The NAIC Insurance Task Force took comments from state regulators and domestic insurance and reinsurance companies. The NAIC requested comments on amending NAIC Model Law #785 and Model Regulation #786, which will determine how best to eliminate the reinsurance collateral requirements for EU reinsurers as required by the Covered Agreement.[94]

The Task Force also took comments about changing the criteria to allow countries to become "qualified jurisdictions" and allowing those qualified jurisdictions to have equivalent reinsurance collateral requirements to those the EU now has.[95] The Task Force is also considering extending the same EU

89. *Id.* at 29–30 ("Except as otherwise specified, this Agreement shall apply on the date of the entry into force, or 60 months from the date of signature of this Agreement, whichever is later.").

90. *Group Capital Calculation (E) Working Group*, *supra* note 82.

91. US-EU Covered Agreement, *supra* note 55, at 30.

92. *About FIO*, *supra* note 1.

93. *Notice of Public Hearing and Request for Comments*, NAIC (Dec. 21, 2017), https://naic.org/documents/cmte_e_reinsurance_related_180220_public_hearing_notice.pdf.

94. *Id.*

95. *See id.* (describing the comments the Task Force solicited).

collateral and group supervision requirements to other countries that the US may enter into a future covered agreement with.[96] The Task Force wants comments to inform its decision on whether the US should give non-EU countries a similar deal to the Covered Agreement and how to determine which countries should get those arrangements. The Task Force also requested comments on what safety precautions to implement to address solvency risks now that the old solvency precaution (collateral requirements) will be eliminated.[97] At the hearing, the Task Force also asked for comments on any other considerations about the implementation of the Covered Agreement brought up by the state insurance regulatory bodies and industry players.[98]

In late February of 2018 the NAIC released an update on the note and comment process and published the comments they received.[99] Twenty entities submitted written comments on the agreement in a wide variety of areas.[100] Some, like the American Insurance Association, proposed specific suggestions for implementation.[101] Other groups, like the Allstate Corporation voiced their concerns about the effect of the agreement.[102] Pleasingly, many of the implementations suggested in the comments are similar to the implementation advocated for by this note.

B. POTENTIAL CONCERNS

When the Covered Agreement was first announced in January 2017, the initial reaction among the affected insurance companies and state regulatory bodies was concern about the potential uncertainties that the Covered Agreement created.[103]

96. *Id.*

97. *See id.* (listing the comments the Task Force requested during the notice and comment period).

98. *Id.*

99. Roland C. Gross, *The NAIC Moves to Implement the Covered Agreement*, 1, CARLTON FIELDS: REINSURANCE FOCUS (Mar. 19, 2018).), https://reinsurancefocus.com/data/20/1/142/136/1957625/user/2137514/htdocs/blog/wp-content/uploads/2018/03/Special-Focus-The-NAIC-Moves-to-Implement-the-Covered-Agreement-3.19.18.pdf.

100. *Id.* at 1–2.

101. *Comment Letters: Covered Agreement Public Hearing Held on February 20, 2018*, NAIC (Mar. 2018), https://www.naic.org/documents/cmte_e_reinsurance_related_180220_public_hearing_comment_letters.pdf.

102. *Id.*

103. US-EU Covered Agreement, *supra* note 55, at 2.

The state regulators were unsure about their roles in the implementation of the Covered Agreement.[104] The Dodd-Frank preemption determination has a long timeframe and loose guidelines for implementation.[105] It was unclear early on if states should act quickly to avoid potential preemption or if they should wait and then challenge any unfavorable preemption decisions in court.[106]

When the Covered Agreement was signed in September 2017, the US and the EU issued a joint statement and each issued their own individual statements to clarify the implementation of the Covered Agreement.[107] Once the regulatory groups and insurance companies received the text of the Covered Agreement and the clarifying fact sheets, some decided that the Covered Agreement would provide increased clarity and stability and would not be as harmful as they initially feared. [108] There are however, still some large concerns currently left unresolved. One main concern of state regulatory bodies and the NAIC is that currently having no collateral requirements for reinsurance companies removes an important protection for consumers and could be potentially harmful for policyholders.[109] The NAIC's other main concern is that their state laws will be preempted by the Covered Agreement.[110] The NAIC is made up of state insurance commissioners and regulators and a finding of preemption here would carve away some of their regulatory power and set a precedent to carve away even more if the USTR enters into any future covered agreements. The NAIC voiced their concerns in a response brief to the announcement of the Covered Agreement:

> The federal government has not demonstrated benefits to US insurers or consumers that would warrant a covered agreement preempting state law. There are alternatives to such drastic action, including state action already underway. However, if Treasury and USTR move forward, state insurance regulators expect to be a

104. *See id.* (stating the NAIC's concerns regarding the Covered Agreement).

105. Dodd-Frank, *supra* note 31 at § 502.

106. *Id.*

107. US-EU Covered Agreement, *supra* note 55, at 2–3 (stating the joint understanding of the agreement).

108. *Id.*

109. *Id.*

110. NAIC GOV'T REL., *supra* note 49, at 4.

> direct part of the negotiations to ensure that mutual recognition is not paid for with unnecessary preemption of state law.[111]

C. TED NICKEL: OBJECTIONS AND RESPONSES

One of the leading voices against the Covered Agreement was former NAIC president, Ted Nickel. The NAIC elects officers from their members for one-year terms.[112] Ted Nickel, Wisconsin Commissioner of Insurance appointed by Governor Scott Walker, was president of the NAIC in 2017, so the USTR was in the process of negotiation and developing the Covered Agreement during his tenure.[113] Nickel laid out his problems with the Covered Agreement in his policy setting newsletter "The Year Before Us: Perspectives from NAIC President Ted Nickel."[114] Nickel's newsletter is a helpful framework for analyzing objections to the Covered Agreement because it outlines some of the most common concerns. One of Nickel's main concerns is that the Covered Agreement treats US reinsurance companies operating in the EU unfairly. In the newsletter he writes:

> Fellow regulators and I are concerned with the disparate treatment some EU jurisdictions are imposing on US insurers. State insurance regulators are committed to reaching accord on a system of mutual recognition without any jurisdiction imposing its values and regulatory systems on another. Both US and EU insurers deserve to receive fair and equal treatment. There should be no disadvantage to an EU insurer doing business in the US Similarly, a US insurer should not be disadvantaged when it operates in the EU.[115]

This worry of disparate treatment is unfounded. EU

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111. *Id.*
112. *Bylaws of the National Association of Insurance Commissioners*, art. 3, NAIC (Dec. 2015), https://www.naic.org/documents/members_bylaws.pdf?90.
113. *2018 Executive (Ex) Committee*, 1, NAIC (2018), https://www.naic.org/documents/members_cmtelist_exec.pdf?38.
114. Ted Nickel, *The Year Before Us: Perspectives From NAIC President Ted Nickel*, 2, NAIC CTR. FOR INS. & POL'Y RES. (Mar. 2017), https://www.naic.org/cipr_newsletter_archive/vol21_real.pdf.
115. *Id.*

regulators can and do treat US insurance companies differently than they treat EU insurance companies without the Covered Agreement. The Covered Agreement will actually end this disparate treatment through the new group supervision requirements.[116] Article Four of the Covered Agreement states that the "Home Party insurance or reinsurance group is subject only to . . . its Home supervisory authorities, and is not subject to . . . any Host supervisory authority."[117] Under the Covered Agreement, EU regulators will not be able to treat US insurance and reinsurance companies unfairly because those companies will not actually be subject to EU requirements. One of the few regulatory powers the host country will have once the Covered Agreement fully enters into force is the ability to request and obtain information from an insurer or reinsurer in its territory for the purpose of prudential insurance regulation and the Covered Agreement encourages host territories to avoid burdensome or duplicative requests.[118] However, the Covered Agreement encourages Host territories to avoid burdensome or duplicative requests whenever possible.

Nickel's next concern, that the EU will impose its "value and regulatory system" on US insurance and reinsurance companies, is similarly misguided. The only specific regulation guidelines in the Covered Agreement are the worldwide group ORSA guidelines, which both the US and the EU already followed.[119] There is a provision in Article Four that allows the Host supervisory authority (the EU in Nickel's fears) to impose "preventive, corrective, or otherwise responsive measures" on a foreign reinsurer if they find that the worldwide group ORSA indicates that the insurance or reinsurance company "exposes any serious threat to policyholder protection or financial stability in the territory of the Host supervisory authority."[120] However, before they can implement any of those measures, the Host supervisory authority needs to consult with that company's Home supervisory authority.[121] There is always a chance that the EU could impose harsh measures against US insurance companies despite consultation from their Home supervisory authority in the US. This outcome seems unlikely because a

116. *See* US-EU Covered Agreement, *supra* note 55, at 18.
117. *Id.*
118. *Id.* at 21.
119. *See id.* at 20 (explaining the ORSA guidelines).
120. *Id.*
121. *Id.*

party is no longer bound by their limitations under the agreement when the other party does not follow their limitations under the agreement.[122]

A worry cited by Nickel and other stakeholders is that the Covered Agreement "needs to better protect US consumers, insurers, and the state-based insurance regulatory system. Our system has a long track record of protecting insurance consumers and promoting competitive insurance markets."[123] However, Nickel believes the US should eliminate the FIO (created to protect consumers through regulatory oversight), give states a voice in monitoring risk, and let the Treasury Department deal with any leftover federal coordination that needs to be done, so his views on consumer protection in insurance are slightly outside the norm.[124]

The standards of protection ensured by the Covered Agreement make up for the consumer protections it removes.[125] While it eliminates reinsurance collateral requirements that protect insurance companies and requires the US to give up some regulatory power over European insurance companies operating in the US,[126] the Covered Agreement sets forth standards for companies that will eventually hold zero collateral. The reinsurers must have at least $250 million (€226 million) in capital and surplus.[127] They must also have a "ratio of 100% SCR (solvency capital requirement) under Solvency II or an RBC (risk-based capital) of 300%, which means the companies hold $3 in capital for every $1 in risk assumed.[128] The reinsurance companies will also have to consent to the jurisdiction of the Host supervisory authority and service of process in the Host country, and to agree to pay any final

122. *U.S. and European Regulators Conclude Covered Agreement Negotiations*, 2, SULLIVAN & CROMWELL LLP (Jan. 16, 2017), https://www.sullcrom.com/siteFiles/Publications/SC_Publication_SC_Publication_U.S._and_European_Regulators_Conclude_Covered_Agreement_Negotiations.pdf.

123. Nickel, *supra* note 114. at 2.

124. *Id*. at 2–3.

125. *See* US-EU Covered Agreement, *supra* note 55, at 1.

126. *See id.* at 9 (explaining the reduction of collateral requirements and changing Home/Host regulations).

127. *Id*. at 11–12.

128. *Id.* at 12; *Annual Conference: Risk-Based Capital*, CRE FINANCE COUNCIL (June 11–13, 2012), http://www.crefc.org/uploadedFiles/CMSA_Site_Home/Events/Major_Conferences/CMSA-Annual_Convention/2012/Wheres_the_MEAF.pdf.

judgments or enforcements sought by a ceding insurer.[129] These standards are safeguards that provide essentially the same level of protection as collateral requirements and add an enforcement mechanism is triggered if the standards are not met, which actually gives consumers an extra level of protection.[130] Because the Covered Agreement makes it so insurance and reinsurance companies do not need to be regulated by their host countries, there is a potential that consumers could lose regulatory protection from EU insurers operating in the US. But again, the Covered Agreement contemplates this danger.

C. WHAT THE STATES SHOULD DO

The states have two options for what to do about the Covered Agreement. One, they can leave their laws the same and wait for FIO to make a preemption determination, invalidate their foreign reinsurance collateral laws, and host presence supervisory authority laws for running counter to the Covered Agreement.[131] Or, two, the states can act quickly to get ahead of the future preemption determination. The NAIC was in the process of reworking their reinsurance collateral model laws when the Covered Agreement was signed.[132] By April 2016, thirty-two states had passed legislation to implement these model laws, which allow certified reinsurers to post less than 100% collateral.[133] The NAIC developed a peer review system to certify foreign reinsurance oversight systems and a few countries within the EU have already been certified.[134] The NAIC is likely capable of certifying the rest of the EU countries individually if they desired.

Unlike the provisions in the Covered Agreement, the NAIC model law does not reduce collateral by a percentage and does not automatically decrease over time.[135] Instead it gives certified reinsurers credit that they can use to do several things, including potentially decreasing required collateral.[136] The NAIC can address this discrepancy in a number of ways. The

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129. US-EU Covered Agreement, *supra* note 55. at 13.
130. *See id.* (describing remedies for violations of the Covered Agreement).
131. *See* NAIC GOV'T REL., *supra* note 49, at 3–4.
132. *See id.* at 1.
133. *Id.*
134. *See id*. (demonstrating the peer review system).
135. NAIC MODEL LAWS, REGULATIONS AND GUIDELINES § III-785 (2016).
136. *See id*. § 785(2) (describing established credit for reinsurance system).

cleanest option would be to create a new model law that mirrors the language of Article Three in the Covered Agreement. Reinsurance collateral requirements would be reduced by 20% each year for countries in the EU.[137] This regulation would have to be coordinated with Model Law #785 so that EU countries that have a better collateral rate under Model Law #785 do not have their percentages raised in the interim.[138] The "qualified jurisdiction" requirements from Model Law #785 align with the requirements in the Covered Agreement in a lot of places so it will not be too much of an adjustment for reinsurers following those laws. Where they do not align, the requirements in Model Law #785 are generally a lower standard than those set forth in the Covered Agreement which makes the adjustment to this new model law less likely to raise concerns about consumer protection standards.[139]

If the NAIC and the states implement laws in accordance with the Covered Agreement, they avoid going through lengthy preemption challenge litigation, avoid setting any precedents for preemption (since it has never happened before), and have more power in how the Covered Agreement will be implemented. All of these things are absolutely in the best interests of the states, so the NAIC and the states should act quickly to write new model laws for the states to adopt.

D. RECENT DEVELOPMENTS

On August 6, 2018, the Reinsurance Task Force met to discuss proposed revisions for Model Law #785 and Model Regulation #786.[140] The proposed revision for Model Law #785 alters the "reciprocal jurisdiction" language to include jurisdictions that have "entered into a treaty or international agreement with the US regarding credit for reinsurance."[141] It also includes language providing that state insurance commissioners can establish other requirements for reinsurers

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137. US-EU Covered Agreement, *supra* note 55, at 28.

138. *See* NAIC MODEL LAW § 785.

139. *Compare* US–EU Covered Agreement, *supra* note 55, *with* NAIC MODEL LAW § 785.

140. *2018 Summer National Meeting, Reinsurance (E) Task Force Monday, August 6, 2018*, NAIC (July 19, 2018), https://www.naic.org/meetings1808/cmte_e_reinsurance_2018_summer_nm_agenda.pdf.

141. NAIC MODEL LAW § 785(F)(1)(a)(i) (NAIC, Tentative Draft June 21, 2018).

in the newly reciprocal jurisdictions, but if reinsurers do not comply, it "will not alter the ability of the ceding insurer to take credit for such reinsurance" so this part of the provision likely would not have a large effect on reinsurers.[142] The proposed revisions to Model Regulation #786 essentially incorporate the standards and requirements set forth in the Covered Agreement for reinsurers that will hold zero percent collateral.[143] The NAIC finished its comment period for the proposed revisions on July 23, 2018 and may adjust the revisions depending on the comments.[144] After any post-comment adjustments, NAIC will formally promulgate the updated model laws and individual states will then decide whether to adopt them.

V. CONCLUSION

Signing on to the Covered Agreement was a meaningful initial step into the global insurance and reinsurance marketplace for the US. Because insurance regulation seems to be following financial regulation in becoming more globally cohesive, it is important that the US participates so it has a say in forming policy and does not get left behind. Aligning US insurance regulatory policy with EU insurance regulatory policy is more complicated and labor intensive than it would be for other countries because of the United States' unique federalist system, in which the individual states can set their own regulatory policy that can govern international deals. Despite concerns raised by the NAIC and state insurance regulators, the Covered Agreement will be positive for the US, because it provides equivalent protections for consumers and insurers and builds on the strides the US has made toward a worldwide group supervisory system. There is a lot yet to be decided as the states move towards implementation, but it is in the states' best interest to embrace the agreement and take a leading role in the implementation process. This Covered Agreement will have many future benefits for insurers and consumers in the US and the EU.

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142. *Id.*§ 785 (F)(1)(h).

143. *See* NAIC MODEL LAW § 786.

144. Rollie Goss, *NAIC Publishes Exposure Drafts of Proposed Revisions to Credit for Reinsurance Models to Implement the Covered Agreement*, CARLTON FIELDS: REINSURANCE FOCUS (July 16, 2018, 1:00 AM), https://reinsurancefocus.com/archives/13291.