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Briefing note

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Impact of EU-US bilateral agreement on insurance and reinsurance prudential measures

On 13 January 2017, the European Commission (the "**Commission**") published a statement made jointly with the Office of the United States Trade Representative announcing that the EU and the US have negotiated a bilateral agreement on prudential measures regarding insurance and reinsurance (the "**Agreement**"). The Commission also published the text of the agreement.

The Agreement has been welcomed by many trade associations and reinsurers since it calls for an end to collateral and local presence requirements for EU and US reinsurers, which have long been an issue for reinsurers operating internationally. This paper highlights the key areas of the Agreement and considers its potential effect on third country (re)insurers, including those in Solvency II equivalent jurisdictions and, following the Brexit referendum result, looks at the potential impact for (re)insurers based in the UK.

Background

The Agreement has been concluded under the legal authority provided by Article 218 of the Treaty on the Functioning of the European Union (the "**TEFU**") for the EU and by Title V of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "**Dodd-Frank Act**") for the US. Therefore, in the US, the Agreement takes the form of a 'covered agreement' within the meaning of the Dodd-Frank Act. In practice, this means that the Agreement, on entry into force, will be legally binding and must be recognised by competent authorities within EU Member States and by State regulators in the US.

The US and the EU (referred to in the Agreement as the Parties) announced

Key areas

The Agreement covers three key areas of prudential insurance oversight:

- **Reinsurance:** Subject to certain conditions, the Agreement eliminates collateral and local presence requirements being imposed on EU and US reinsurers as a condition to entering into a reinsurance agreement with a cedant based in the other party's territory or that cedant taking credit for the reinsurance.
- **Group supervision:** Subject to certain conditions, the Agreement allows US and EU (re)insurance groups operating in the other market to be subject to worldwide prudential insurance group oversight only by the supervisors in their home jurisdiction. However, other supervisors will be able to request and obtain information about worldwide activities that could harm policyholders' interests or financial stability in their territories and, in certain circumstances, take action in respect of this.
- **Exchange of information:** The Agreement is intended to encourage US and EU supervisory authorities to exchange supervisor information on (re)insurers that operate in US and EU markets. The Agreement includes an annex which sets out model memorandum of understanding provisions.

the beginning of negotiations in November 2015, although informal discussions had been going on for some years, and after a year of silent negotiations took the market somewhat by surprise when they announced they had reached agreement just a week before the inauguration of the new US President.

Reinsurance

Elimination of collateral and local presence requirements

Subject to the conditions summarised below, the Agreement effectively prevents a US State regulator from imposing on an EU assuming reinsurer either collateral or local presence requirements that it does not also impose on a US assuming reinsurer as a condition to a reinsurance agreement being entered into with a US cedant, or that cedant taking credit for the reinsurance. Equally, an EU Member State regulator cannot impose on a US assuming reinsurer collateral or local presence requirements that it does not also impose on an EU assuming reinsurer (Article 3(1)-(3)).

Conditions

To qualify for the collateral and local presence benefits under the Agreement, an assuming reinsurer must meet several conditions (Article 3(4)), which include:

- own funds or capital and surplus of at least US$250 million (when dealing with a US ceding insurer) or EU€226 million (when dealing with an EU ceding insurer);
- a Risk-Based Capital ("**RBC**") ratio of 300% Authorised Control Level or a solvency ratio of 100% Solvency Capital Requirement ("**SCR**") under Solvency II;
- a practice of prompt payment of reinsured claims;
- a 'service of process', where applicable, in the host party; and
- consent in writing to pay all final judgments obtained by a ceding insurer in the courts of where the judgement was obtained.

The assuming insurer must also provide certain information to the host supervisory authority if requested. We have seen reports implying that EU insurers may be able to reclaim as much as US$40 billion provided as collateral in the US.

However, it is worth noting that the Agreement applies only to reinsurance agreements entered into, amended, or renewed on or after the date on which a measure that reduces collateral takes effect, and only with respect to losses incurred and reserves reported from and after the later of (i) the date of the measure, or (ii) the effective date of such new reinsurance agreement, amendment, or renewal (Article 3(8)). This provision, therefore, effectively limits the ability of reinsurers to reduce their collateral obligations on in-force business that is already reinsured and has existing collateral.

Background to collateral measures

Historically, non-US insurers have been required to fully collateralise their reinsurance obligations to US ceding insurers, although in certain US States this has been relaxed. Such collateral requirements have long been considered by many EU reinsurers and Lloyds of London syndicates to be overly restrictive trade barriers that are not conducive to effective competition between EU reinsurers and their American competitors, not least because EU reinsurers are also subject to (comparably more stringent) Solvency II capital requirements. These collateral measures are therefore of particular importance to EU reinsurers in ensuring they are able to operate more competitively in the US market.

Group supervision

Worldwide group oversight

The Agreement provides that, subject to various exceptions, an EU or US headquartered (re)insurance group is subject to worldwide prudential insurance group supervision (including worldwide group governance, solvency, capital and reporting requirements) only by the supervisory authorities of the jurisdiction where the worldwide parent of the group is domiciled or headquartered (Article 4(1)).

Therefore, a US headquartered (re)insurance group operating in the EU will be subject to worldwide group-level insurance prudential supervision only by its applicable primary US insurance regulator(s), although its EU operations will continue to be subject to EU group supervision in respect of the sub-group operating in the EU. Equally, an EU (re)insurance group operating in the US will be subject to worldwide group-level insurance prudential supervision only by the respective Member State home regulator, although its US operations will continue to be subject to US group supervision in respect of the sub-group operating in the US. This will be of particular benefit to US headquartered insurance groups as it will limit the extra-territorial application of the Solvency II group supervision requirements in their worldwide operations.

Worldwide group ORSA

The Agreement includes reference to a worldwide group Own Risk and Solvency Assessment ("**ORSA**") and shows that the ORSA is quickly becoming a global regulatory requirement for (re)insurers, especially following the International Association of Insurance Supervisors ("**IAIS**") decision to require an ORSA as part of Insurance Core Principle 16 on Enterprise Risk Management ("**ERM**"). With respect to group supervision, the Agreement provides that a worldwide ORSA (or equivalent documentation where an ORSA is not produced) must include the following elements (Article 4(d)):

- a description of the insurance or reinsurance group's risk management framework;
- an assessment of the insurance or reinsurance group's risk exposure; and
- a group assessment of risk capital and a prospective solvency assessment.

Host supervisors preserve the ability to request and obtain a summary of the worldwide group ORSA (Article 4(c)(i) and (ii)) and could impose 'preventive, corrective, or otherwise responsive measures' where the summary exposes any serious threat to policyholder protection in their territory (Article 4(e)).

Exchange of information

The Agreement provides that the US and EU shall encourage their respective supervisory authorities to cooperate in exchanging information in accordance with the practices set out in a memorandum of understanding, annexed to the Agreement (Article 5). The intention is that the use of such practices will enhance cooperation and information sharing while respecting a high standard of confidentiality protection. However, the Agreement does not address requirements that may apply to the exchange of personal data by supervisory authorities.

Implementation

Given the perception in some quarters of a hurried deal in the last weeks of the Obama administration and the protectionist rhetoric of the Trump administration (as well as potential industry body or US State challenges), it remains to be seen whether the Agreement will attain the necessary sign-off. Should such sign-off be obtained, the Agreement will enter into force seven days after the date on which the EU and US exchange written notifications certifying that each has completed its respective internal requirements and procedures, or as otherwise agreed (Article 8).

For the EU, the internal procedures include consultation (concluding with formal adoption) by the Commission with the European Council and European Parliament. In the US, the procedural requirements are as follows: submission to the House Financial Services, House Ways and Means, Senate Banking and Senate Finance Committees on a day the House and Senate are in session, followed by a waiting period of 90 days. Submission of the Agreement to Congress on January 13 was intended to comply with these requirements and start the 90 day clock.

Full application is expected to be on the later of the Agreement coming into force and the expiration of five years from signing (Article 10), however, the Agreement sets out, on a provision-by-provision basis, specific timelines for implementation of the Agreement with some obligations provisionally applying from signing, for example, the group supervision provisions in Article 4 and the obligations not to take any measures inconsistent with the Agreement.

It should be noted that there is conditionality between the obligations of the parties to avoid the possibility of one party benefiting whilst failing to follow through with its obligations so that the other cannot benefit. For example, the US would not be required to implement the reinsurance collateral elimination provisions of the Agreement if the EU fails to comply with the terms of the Agreement on group supervision and local presence. Similarly, the EU could re-apply Solvency II group supervision requirement to US (re)insurers if the US fails to meet its obligations to eliminate collateral requirements.

Industry reaction

The Agreement appears to have been widely welcomed by the insurance industry in the US, although, since the negotiations were conducted in secret, the National Association of Insurance Commissioners ("**NAIC**") has stated its intention to review the Agreement to ensure that it meets the conditions to be a 'covered agreement' under US law and is not being used as a backdoor to force foreign regulations on US companies.

In a joint statement, the American Insurance Association, the American Council of Life Insurers and the Reinsurance Association of America noted that they "welcomed the successful conclusion of covered agreement negotiations between the United States and European Union". They noted that the Agreement "seeks to resolve significant insurance and reinsurance regulatory issues for companies doing business

in both jurisdictions" and that they had "long supported the covered agreement process".

The Agreement also appears to have been well received by the EU reinsurance industry. The International Underwriting Association has commented that the Agreement seems likely to lead to a "more level playing field" between EU and US reinsurers, "both in terms of collateral treatment and mutual recognition of two powerful and respected trading blocs". Insurance Europe has also commented that the Agreement removes "discriminatory collateral requirements that EU reinsurers were subject to when placing business in the US".

Solvency II equivalence

Solvency II provides for the EU to make an equivalence determination for non-EU countries in the areas of group supervision, group solvency and reinsurance. In June 2015, the EU Commission granted the US provisional equivalence (i.e. for a period of 10 years, which is renewable) with regard to group solvency. This means that, where the 'deduction and aggregation method' is used for the group solvency calculation, the contribution of a US insurer subsidiary to the group solvency calculation, based on local rules, can be taken into account and this is a huge benefit for internationally active EU groups.

Now that the Agreement establishes equivalent treatment of US (re)insurers in respect of group supervision and reinsurance, the Commission could potentially grant the US unqualified equivalency status, as this would be a simpler way to benefit EU entities from a capital perspective and also simplify their supervision. However, it is not clear that the US wants 'equivalence' politically, perhaps preferring a bilateral agreement.

Third country (re)insurance undertakings which currently benefit from Solvency II equivalence decisions (for example, those headquartered in Switzerland and Bermuda) are not expected to benefit from the Agreement directly, since these countries are not party to it. However, their authorised EU subsidiaries will benefit directly from the Agreement, and also benefit directly from group supervision reciprocity with the EU. It may be that the regulators of such third country (re)insurance undertakings consider that they are now better placed to reach a similar agreement with the US allowing for reciprocal access should there be demand from their regulated (re)insurance groups.

Brexit

When it exits the EU, the UK will not be able to benefit from the Agreement. It seems likely that the UK and potentially also the US will wish to put in place a bilateral agreement on similar or better terms. Such an agreement could form part of a wider trade deal between the UK and the US, but as such deals are complicated and take time to negotiate (despite President Trump's stated desire to agree to a deal quickly), a stand-alone agreement (perhaps using the Agreement as a starting point) could save significant time.

Pre-emption of State law

The Agreement pre-empts US State law, thereby encouraging regulatory uniformity at a national level. The US will, from the date of entry into force or provisional application of the Agreement (whichever is earlier), encourage each US State promptly to adopt the following measures (Article 9):

- the annual reduction by 20% of the amount of collateral required by each US State to allow cedants to take full credit for reinsurance; and
- the implementation of relevant US State credit for reinsurance laws and regulations consistent with the Agreement; and
- no later than 42 months following execution of the Agreement (providing the Agreement has entered into force), the US will begin evaluating potential pre-emption determinations under its

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Clifford Chance also has a dedicated Brexit team monitoring political developments closely and also working closely with our leading insurance practice to help identify the specific Brexit risks and possible solutions for your insurance or reinsurance business. We also work with industry groups and have the experience to assist with lobbying on post-Brexit arrangements for the sector.

laws and regulations with respect to any US State insurance measure that the US determines is inconsistent with the Agreement.

The pre-emption review referred to above must be completed within 60 months following execution of the Agreement and demonstrates a commitment by the US to allow for a consistent State-by-State approach to reinsurance which will be of particular benefit to EU reinsurers. Despite the potentially adverse current political climate, exemplified by the protectionist rhetoric of the Trump administration, it seems difficult to argue that a narrowly tailored covered agreement that creates an equal platform for reinsurance and collateral would not be, at least in theory, beneficial for all participants in the insurance markets.

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