Covered Agreement on Reinsurance Collateral

What is Reinsurance Collateral?

- Historically, U.S. insurance regulators have required non-U.S. reinsurers to hold 100% collateral within the U.S. for the risks they assume from U.S. insurers. As reinsurers are ultimately providing insurance to other insurance companies that are directly protecting U.S. policyholders, requiring collateral in the U.S. is intended to ensure claims-paying capital is available and reachable by U.S. firms and regulators should it be needed, particularly in the wake of a natural disaster.

- Foreign reinsurers’ regulators and politicians have objected to their companies having to post collateral in the U.S. as such capital is unavailable for other purposes, including investment opportunities.

What are state regulators doing about collateral?

- Recognizing that the potential for variation across states makes planning for collateral liability more uncertain and thus potentially more expensive, state regulators have been working together through the NAIC to reduce collateral requirements in a consistent manner commensurate with the financial strength of the reinsurer and the quality of the regulatory regime that oversees it.

- Recently, the NAIC passed amendments to its “Credit for Reinsurance Models” that once implemented by a state, will allow foreign reinsurers to post significantly less than 100% collateral for U.S. claims, provided the reinsurer is evaluated and certified.

- 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 establish “qualified jurisdictions” for purposes of reduced collateral. To date, Bermuda, Germany, Switzerland, and the U.K. have been qualified. Evaluations of Japan, Ireland, and France are underway.

- The NAIC has also established a peer review system surrounding the certification of foreign reinsurers by states, which provides a foreign reinsurer an opportunity for a passport throughout the U.S. To date, more than 30 foreign reinsurers have been certified under this peer review system.

- In light of the progress made by the NAIC and the states to modernize credit for reinsurance rules, the NAIC is neither convinced nor persuaded that a covered agreement for reinsurance collateral is necessary. To date, 23 states have passed legislation, representing 60% of premium, to implement the revised NAIC Credit for Reinsurance Models and an additional five states have indicated their plans to do so in the coming months, which would raise the total market coverage to 80%.
What is a Covered Agreement?

- The notion of a ‘covered agreement’ was included in the Dodd-Frank Act as unique stand-by authority for Treasury and the United States Trade Representative (USTR) to address, if necessary, those areas where U.S. state insurance laws or regulations treat non-U.S. insurers differently than U.S. insurers, such as reinsurance collateral requirements.

- A covered agreement is a bilateral or multilateral agreement among the United States and foreign jurisdiction(s) regarding the recognition of regulatory measures with respect to the business of insurance or reinsurance.

- A regulatory measure subject to a covered agreement must achieve a level of protection for consumers that is “substantially equivalent” to the level of protection achieved under state law. To be substantially equivalent to the level of protection achieved under state law, a measure must achieve a similar outcome in consumer protection as the outcome achieved under state law.

- A covered agreement can serve as a basis for preemption of state law under certain circumstances.

What steps must be followed to enter into a covered agreement?

- A covered agreement is negotiated jointly by the U.S. Treasury’s Federal Insurance Office (FIO) and the USTR with foreign authorities.

- Before initiating negotiations, during the negotiations, and before entering into a covered agreement, the Treasury Secretary and USTR must jointly consult with the House Financial Services Committee, House Ways and Means Committee, Senate Banking Committee, and Senate Finance Committee. At a minimum, such consultation is required to cover: 1) the nature of the agreement, 2) how and to what extent such agreement will achieve the purposes of Title V of the Dodd-Frank Act, which established FIO, and 3) the implementation of the agreement and its effect on state laws.

- A covered agreement can only enter into force if the FIO and USTR follow the submission and layover provisions of Title V of the Dodd-Frank Act, which require the FIO and USTR to jointly submit the agreement 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 and wait for a period of 90 days to elapse.

How can a covered agreement preempt state law?

- A state insurance measure can only be preempted if the FIO Director determines that:
  - 1) The measure results in less favorable treatment of a non-U.S. insurer domiciled in a foreign jurisdiction that is subject to a covered agreement, than a U.S. insurer domiciled, licensed, or admitted to do business in that state.
  - 2) The measure is inconsistent with a covered agreement.
The scope of the review for such determination is limited to:
  1) The subject matter contained within the covered agreement involved.
  2) Whether the subject matter of the agreement achieves a level of protection for insurance consumers that is substantially equivalent to the level of protection achieved under state law.

Before a state law can be preempted, the FIO Director is required to:
  1) Notify and consult with the appropriate state regarding any potential preemption.
  2) Notify and consult with the USTR regarding any preemption.
  3) Publish for in the federal register for public comment a notice of the potential preemption including a description of each state insurance measure at issue and any applicable covered agreement.

Upon making a determination of a preemption, the FIO Director is required to:
  1) Notify the appropriate state of the determination,
  2) Establish a reasonable period of time for the preemption to become effective, and
  3) Notify the relevant Congressional committees of such preemption.

Once the preemption has become effective, the FIO Director is required to:
  1) Publish another notice in the Federal Register.
  2) Notify the appropriate state.

A state has a right to appeal this determination in court pursuant to the provisions of the Administrative Procedures Act and such appeal shall be considered under a de novo standard of review (i.e. without judicial deference to the FIO Director’s determination).

Not all insurance regulatory measures can be preempted. The following state laws and regulations cannot be preempted:
  1) Those governing rates, premiums, underwriting, or sales practices;
  2) State insurance coverage requirements;
  3) State antitrust laws relating to the business of insurance; and
  4) Those relating to capital and solvency except to the extent that such measure results in less favorable treatment for non-U.S. insurers than U.S. insurers.

What is the NAIC’s position regarding a covered agreement on reinsurance collateral?

To the extent Treasury and the USTR maintain that a covered agreement is in the best interests of the United States, we continue to have a number of questions, including:
  1) What is the scope of the agreement? How narrow is it? Is it limited to reinsurance collateral or does it extend to other topics?
What is the cost-benefit for the United States? Requiring all states to eliminate collateral requirements for foreign reinsurers would clearly help non-U.S. companies, but is there a corresponding benefit to U.S. companies and policyholders?

- For example, a covered agreement that resulted in fair treatment of U.S. firms in Europe and did not undermine consumer protection in America might be worth exploring if the benefit to the United States insurance sector is made crystal clear and long-term rather than temporary or provisional.

- How will the agreement be substantially equivalent to the protections afforded U.S consumers under state insurance laws? Reinsurance collateral protects insurance consumers by ensuring that reinsurers pay on their claims to ceding insurers, who in turn, rely on such coverage to pay consumer claims. Reducing collateral beyond a prudent risk-based regulatory assessment, as the NAIC approach provides, may increase the likelihood that reinsurance claims may not be paid, in full or on time, thereby potentially increasing risks to U.S insurers and policyholders.

While the USTR and FIO have the authority to pursue such negotiations, it is imperative that the NAIC and state insurance regulators be directly engaged in discussions that impact the U.S. insurance regulatory system. Moreover, it is important for policymakers to keep in mind that states could have a good reason to challenge a federal preemption determination based on a covered agreement, so it only makes sense to include them directly in the process from the outset.