CLIENT MEMORANDUM

U.S. and EU Complete Negotiations of Covered Agreement

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On January 13, the U.S. Department of the Treasury ("Treasury") and the Office of the U.S. Trade Representative ("USTR") notified Congress that they had negotiated a bilateral trade agreement with the European Union ("EU"), known as a "covered agreement." The covered agreement addresses three areas of insurance regulation: group supervision, reinsurance and the exchange of information between insurance supervisors. Treasury and USTR also delivered to Congress a copy of the final legal text of the covered agreement. The U.S. and EU (referred to as the "Parties") had held private negotiations for over a year; however, the news of the successful negotiation of a covered agreement was a surprise.

The Treasury and USTR are authorized to jointly negotiate covered agreements under the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank"). For the past several years, the Parties have debated whether a particular supervisory system, such as the Solvency II model, should be used as the basis for identifying "equivalency" by other jurisdictions.[1] State insurance regulators and the National Association of Insurance Commissioners ("NAIC") have rejected the concept of "equivalence" in favor of mutual recognition. The covered agreement does not mention the concept of "equivalence." Rather, with respect to both reinsurance and group supervision, it establishes mutually binding

[1] See the discussion below under "Impact of Covered Agreement on Solvency II Equivalence."

prudential insurance standards. In addition, and importantly for state regulation, the covered agreement contemplates that in the United States it will be implemented by the states by incorporating its standards into state law. However, if state law is not amended to incorporate such standards and disadvantages an EU insurer, the Federal Insurance Office ("FIO") is authorized to preempt the offending state law.

As a first of its kind, the U.S./EU covered agreement will present complex legal issues and potential legal challenges. The outgoing administration concluded the negotiations, and the new administration's reaction is not known.

REINSURANCE

For many years, EU-domiciled reinsurers have asserted that state reinsurance laws impose excessive and unnecessary reinsurance collateral requirements on them (and not on U.S. reinsurers), resulting in an unfair trade barrier. In response to complaints regarding the unequal application of full collateral requirements, the NAIC adopted changes to the Credit for Reinsurance Model Act and Credit for Reinsurance Model Regulation to reduce a non-U.S. reinsurer's collateral obligations, provided the reinsurer satisfies certain financial and jurisdictional requirements. To date, 35 states have adopted this reduced reinsurance collateral model, and have approved many EU reinsurers for reduced collateral. The NAIC construct has been incorporated, in part, into the covered agreement. Significant differences include: (i) the elimination of the concept of "qualified jurisdictions," since reinsurers domiciled in all EU countries will be eligible for the elimination of the collateral requirements; and (ii) the fact that collateral requirements will be reduced to zero, regardless of the ratings of the reinsurer.

On the other hand, U.S. insurers and reinsurers claim that reinsurance trade restrictions exist in the EU, particularly in nations that require a "local presence."

The U.S and EU agree in the covered agreement to ensure that their supervisory authorities will not impose reinsurance collateral requirements or "local presence" requirements on a reinsurer domiciled in (or with a head office in) the other Party's territory that are less favorable than collateral or local presence requirements applied to a domestic reinsurer. However, the removal of these barriers is not absolute; rather, the collateral or local presence provisions apply only if the insurer or reinsurer satisfies certain conditions and standards. Those standards include, among others, minimum capital and risk-based capital ("RBC"); confirmation of financial condition by the reinsurer's domestic regulator; claims payment standards; and agreeing to receive service of process and consent to the jurisdiction of the cedent's head office or domicile.

GROUP SUPERVISION

In general, under the covered agreement, a U.S. or EU insurance or reinsurance group is subject to <u>worldwide</u> group supervision (including governance; solvency and capital; and reporting) only by the Party (referred to as the "Home Party") where the ultimate/worldwide parent has its head office or is domiciled. However, if the insurance group also operates in the other Party's territory (referred to as the "Host Party") then, where appropriate, the Host Party may exercise supervisory authority over an insurance or reinsurance group, but only at the level of the parent holding company located in its jurisdiction and not on a worldwide level. There are situations, however, when the Host Party may exercise worldwide group supervision: (i) with respect to systemically significant financial systems or groups comprising banking operations; and (ii) to require group reporting directly related to a serious risk on the ability of the group members to pay claims in the Host Party's territory.

Although, in general, the Home Party is the ultimate group regulator, the Host Party can exercise jurisdiction over operations in its territory as described below:

1. Actions in Response to ORSA Filings. The Home Party shall apply a worldwide Own Risk and Solvency Assessment ("ORSA") (or equivalent documentation) to be shared with Host supervisors. After consulting with the Home Party, the Host Party may impose preventive, corrective or otherwise responsive measures with respect to insurers or reinsurers in its territory in the event an ORSA "exposes any serious threat to policyholder protection or financial stability" in the territory. The covered agreement also states that the United States and the EU "encourage" supervisory authorities to continue to address prudential insurance group supervision matters within supervisory colleges.

2. Ability to Request Certain Information. The Host Party may request and obtain information, for purposes of prudential insurance group supervision, but *only* if such information is deemed necessary to "protect against serious harm to policyholders or serious threat to financial stability or a serious impact on the ability of an insurer or reinsurer to pay its claims" in the territory. Any such information request must be based on prudential supervisory criteria, and, "whenever possible," must avoid burdensome and duplicative requests. The supervisory college must be informed of any such request.

3. Group Capital. A Host Party may not impose a group capital assessment or requirement on worldwide group operations provided:

    a. The Home Party group capital assessment includes a worldwide group capital calculation that captures risk at the level of the entire group, including undertakings in the Host Party; and

    b. The Home Party supervisor is authorized to impose preventive, corrective, or otherwise responsive measures on the basis of the assessment—including requiring, where appropriate, capital measures.

Assuming the covered agreement becomes effective, these group capital standards will likely inform group capital provisions currently under development by the NAIC, and the group capital standards being developed for U.S. SIFIs by the Board of Governors of the Federal Reserve System.

Certain Supervisory Statutory Schemes Excluded. As noted above, the covered agreement expressly states that it does not limit the ability of EU or U.S. supervisory authorities to exercise supervisory or regulatory authorities over certain types of entities or groups, including, *e.g.*, entities that control depository/credit institutions or have banking operations in the EU or United States, and entities or groups that could pose a threat to the financial stability of the EU or the United States.

Impact of the Covered Agreement on Solvency II Equivalence. The originally announced set of goals for the covered agreement negotiations included: (i) obtaining treatment of the U.S. insurance regulatory system by the EU as "equivalent" to allow for a level playing field for U.S. insurers and reinsurers operating in the EU, and (ii) obtaining permanent equivalent treatment for the solvency regime in the United States that is applicable to insurance and reinsurance undertakings. As background, the EU's Solvency II regulatory regime, which came into force on January 1, 2016, has given rise to restrictions on U.S. insurers and reinsurers that are not deemed to be subject to a regulatory regime that is "equivalent" under Solvency II. Equivalence is the concept whereby the EU determines whether the insurance regulatory regime of a non-EU country is equivalent to Solvency II for the purposes of group solvency calculation, group supervision and reinsurance.

The final text of the covered agreement does not expressly address the concept of equivalence for the U.S. insurance regulatory regime under Solvency II. However, the covered agreement broadly addresses the three areas of equivalence set forth above. As a result, it is arguable whether U.S. regulators will deem it necessary to separately negotiate with the EU for full equivalency status. We note that the United States was granted provisional equivalence under Solvency II for the purposes of group solvency calculation for a 10-year period, starting as of January 1, 2016.

EXCHANGE OF INFORMATION AMONG SUPERVISORS/JOINT COMMITTEE

The covered agreement includes a provision "encouraging" insurance supervisory authorities in the United States and the EU to cooperate in exchanging supervisory information, and the covered agreement includes a model memorandum of understanding provisions to be used by supervisors to facilitate information exchange. In addition, the Parties establish a Joint Committee composed of U.S. and EU representatives providing the Parties a forum for consultation and the exchange of information on the administration and implementation of the covered agreement.

IMPLEMENTATION

Effective Dates

Putting U.S. and EU internal politics aside, the covered agreement sets forth a time frame for its approval and effective date, provisional implementation of group supervision matters and changes in the Parties' current laws to effect the reinsurance provisions.

Under Dodd-Frank, a period of 90 calendar days following the date of submission of the final text of the covered agreement to the U.S. Congress must expire before the covered agreement may enter into force. In addition, on the EU side, the European Council and the European Parliament must each adopt decisions approving the covered agreement before it can come into force. The covered agreement sets out, on a provision-by-provision basis, time frames for implementations. For example, the group supervision provisions will become applicable on a provisional basis upon the Parties' execution of the covered agreement. The states have five years (60 months) from execution of the covered agreement to remove from their laws collateral requirements for EU reinsurers, and FIO will begin the process of making preemption determinations of state laws that are inconsistent with the covered agreement after 42 months. Within 24 months of execution of the covered agreement, the EU Member States will revise existing laws so that U.S. reinsurers can operate in the EU without establishing a branch or subsidiaries and local presence requirements will not be imposed on U.S. reinsurers.

In addition, there is a conditionality between the obligations of the two Parties so that one Party cannot benefit from failing to follow through with the agreement while the other provides the agreed benefits. As described by the Treasury:

> [T]he United States would not be required to implement the reinsurance collateral elimination provisions … 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 requirements to U.S. insurers' worldwide operations if the United States does not complete the necessary reinsurance reform within five years.

Politics and the Covered Agreement

Dodd-Frank does not provide any express statutory authority to the U.S. Congress to disapprove the negotiated covered agreement in its current form or require that any amendments be made to the covered agreement. However, Congress could choose to exercise its authority to amend provisions of Dodd-Frank governing the covered agreement's entry into force, or definition of a covered agreement. Further, the U.S. Congress has a variety of general authorities under which it could make implementation of the joint agreement by federal agencies difficult or impossible, including authority to prohibit the expenditure of federal funds for such implementation.

The Trump Administration Could Choose to Terminate the Covered Agreement. It is uncertain how the Trump administration will view the covered agreement. Negotiations of the covered agreement proceeded on an accelerated timeline following the U.S. presidential election and were completed merely a week before the inauguration of President Trump. As a result, we expect that the Trump administration would, at a minimum, consider whether the implementation of the covered agreement should be prevented. The Trump administration's stance toward the covered agreement could also be shaped by the newly appointed USTR, Robert Lightizer, and/or the newly appointed Director of FIO (presuming that FIO remains in existence following any potential roll-back of Dodd-Frank).

We note that the covered agreement includes a provision permitting either Party thereto to terminate the covered agreement at any time on 180 days' notice and after the Parties have engaged in mandatory consultations via a joint committee established under the covered agreement. As a result, if desired, the Trump administration would have a fairly straightforward path to terminating the covered agreement, either before or after the covered agreement in-force date. We note that, during his presidential campaign last year, President Trump stated on numerous occasions that he would not hesitate to invoke the termination provisions under other global trade agreements, including the Transatlantic Trade and Investment Partnership (T-TIP) and the North American Free Trade Agreement (NAFTA); on January 23, 2017, President Trump signed an executive order to withdraw the United States from T-TIP.

As a result, even though covered agreement negotiations between the United States and the EU have concluded, question marks remain over the two sides' ability to implement the covered agreement in the future.

We will continue to monitor further developments in this area.

If you have any questions regarding this memorandum, please contact Leah Campbell (212-728-8217, lcampbell@willkie.com), Donald B. Henderson, Jr. (212-728-8262, dhenderson@willkie.com), Allison J. Tam (212-728-8282, atam@willkie.com) or the Willkie attorney with whom you regularly work.

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