Statement

of the

National Association of Mutual Insurance Companies

to the

United States

House Financial Services Subcommittee

On Housing and Insurance

Hearing on

Assessing the U.S.-EU Covered Agreement

February 16, 2017

The National Association of Mutual Insurance Companies (NAMIC) is pleased to provide comments to the House Financial Services Subcommittee on Housing and Insurance on the recently completed U.S.- European Union (EU) covered agreement dealing with insurance regulation. We appreciate the subcommittee's focus on an important matter that has the potential to greatly impact the domestic U.S. property/casualty insurance industry.

NAMIC is the largest property/casualty insurance trade association in the country, with more than 1,400 member companies representing 39 percent of the total market. NAMIC supports regional and local mutual insurance companies on main streets across America and many of the country's largest national insurers. NAMIC member companies serve more than 170 million policyholders and write more than $230 billion in annual premiums. Our members account for 54 percent of homeowners, 43 percent of automobile, and 32 percent of the business insurance markets.

Introduction

In 2010, the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank) created a new office in the Department of Treasury called the Federal Insurance Office (FIO). Although given no explicit regulatory authority, the new office was empowered, in conjunction with the United States Trade Representative (USTR), to negotiate and enter into international "covered agreements" on insurance regarding prudential measures. These agreements are between the U.S. and one or more foreign governments or regulatory entities and must "achieve a level of protection for insurance or reinsurance consumers that is substantially equivalent to the level of protection achieved under State insurance or reinsurance regulation."

The "covered agreement" concept was wholly created by and defined in the Dodd-Frank Act. It is an invented term for insurance and not a standard type of contract, covenant, understanding or rule, subject to existing and recognized practices and requirements. The scope of a covered agreement is not well-defined in statute, but the Dodd-Frank Act provided the power to preempt state insurance laws that are inconsistent with the agreement and result in less favorable treatment of a non-U.S. insurer domiciled in a foreign jurisdiction that is subject to a covered agreement. Exactly how these agreements are to be negotiated, entered into, and applied are subject to interpretation of the high-level guidelines in Dodd-Frank. Many questions remain concerning these agreements, the policy decisions at the outset and throughout negotiations, as well as the application of these agreements, and the rights of parties to participate in and/or challenge them.

NAMIC has long had serious concerns about the use of an international trade negotiation process to alter or preempt the state-based system of insurance regulation. We have argued that the USTR and the FIO should exercise such authority only if they determine that extreme circumstances demand it, and then only after full and

transparent due process, including consultation with state legislative and regulatory authorities and public exposure of the policy objectives of the negotiations.

Our analysis of the recently finalized draft agreement validates our long-held concerns. Despite claims otherwise, we believe that the covered agreement does not address the problems the FIO and USTR committed to resolve when the negotiations were started. To be clear, those companies that are being threatened by increased regulatory burdens by EU regulators need relief and we are in favor of providing them with that relief. However, the agreement is ambiguous and unclear and does not provide sufficient protections and benefits for the U.S. insurance market and consumers. As drafted the agreement represents a bad deal for the U.S. domestic property/casualty insurance industry. The U.S. can – and must – do better.

Currently, the agreement sits in Congress for a 90-day layover period, which is intended to provide lawmakers the opportunity to review and provide comment on the agreement. However, the agreement does not require congressional approval. At the end of the 90 days, Treasury and USTR may bring it into effect. This 90-day period began to run seven days before the new President was inaugurated, before the new Treasury Secretary or U.S. Trade Representative was confirmed, and after the key U.S. negotiators had resigned their positions. That said, Congress should urge the Trump Administration to go back to the drawing board and secure a better deal.

Covered Agreement Negotiations

On November 20, 2015, the FIO and USTR officially sent a letter to Congress announcing the initiation of negotiations for a covered agreement between the U.S. and the EU, notification required by Dodd-Frank. Over the course of a year, representatives from the U.S. and the EU met five times in person for negotiations. These meetings were followed by a series of telephone negotiations at the end of President Obama's second term. Finally, in the last week of the Administration, on Friday, January 13, 2017, USTR and the FIO released the final negotiated covered agreement language.

The impetus for the initiation of negotiations was the pending 2016 implementation of the EU's insurance regulatory reform known as Solvency II. Under the new regime, an insurer doing business in the EU is subjected to heightened regulatory and capital requirements in the event that the insurer's country of domicile is not deemed "equivalent" for purposes of insurance regulation. U.S.-based insurers had begun receiving threatening letters from EU regulators suggesting that because the U.S. had not been deemed equivalent, they stood to be penalized which would make them less competitive. While this created a real and present difficulty for the small number of insurers doing business overseas, the need for "equivalency" was completely manufactured by the EU in their enactment of Solvency II.

It is likely that the EU leveraged its Solvency II equivalency determination to pressure the U.S. to negotiate more favorable treatment for its reinsurers. Foreign-based reinsurers have long chafed at the requirement in the states that they must post collateral in the U.S. for ceding insurers to get credit for purchasing their reinsurance. This problem was addressed by the NAIC in their 2011 revised model Credit for

Reinsurance Act. In that model act they provided for a staggered collateral system based on the credit rating of foreign reinsurers from qualified jurisdictions. Despite the passage of that model in more than 35 states, the goal of the EU has always been to quickly and uniformly eliminate the requirements for reinsurance collateral in the U.S. for the benefit of EU reinsurers.

Whatever the case, many of the U.S. companies that do business internationally urged the FIO and USTR to move quickly to negotiate a covered agreement with the primary goal to settle – promptly and finally – the question of U.S. insurance regulatory equivalence with the EU under Solvency II. With the two sides' goals in mind, the 2015 letter announcing the initiation of negotiations laid out the prudential measures the covered agreement would seek to address:

1. Obtain 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;
2. Obtain recognition by the EU of the integrated state and federal insurance regulatory and oversight system in the United States, including with respect to group supervision;
3. Facilitate the exchange of confidential regulatory information between lead supervisors across national borders;
4. Afford nationally uniform treatment of EU-based reinsurers operating in the United States, including with respect to collateral requirements;
5. Obtain permanent equivalent treatment for the solvency regime in the U.S. and applicable to insurance and reinsurance undertakings.[1]

As we will discuss in more detail below, even by the standards laid out by USTR and the FIO the negotiated covered agreement is a failure for the United States. There is no finding that U.S. group supervision is permanently adequate, mutual, or equivalent. The EU has only agreed to return to pre-Solvency II status quo when they were not unfairly punishing U.S.-based insurers for the U.S. state laws.

The Covered Agreement

The covered agreement allows for a period of five years to phase-in provisions which address three prudential areas – Reinsurance Collateral, Group Supervision, and Confidential Exchange of Information. The agreement also sets up a permanent "joint committee" to oversee implementation and to consider amendments in the future. NAMIC believes that on the whole there are more negative provisions than added value especially for those insurance companies that only write in the U.S. For companies writing internationally who need to rely on this agreement the most, its ambiguity raises significant questions about what they can count on from the EU insurance supervisors, if U.S. regulators will meet the obligations they were not involved in negotiating, and whether they will be disadvantaged by one of the many exceptions to the agreement.

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[1] November 20, 2015 letter from the U.S. Treasury Department and the Office of the United States Trade Representative to Congressional Committee leadership announcing initiation of covered agreement negotiations with the European Union.

These companies and those who represent them are "hopeful" things will work out and they want to believe that everyone will abide by the intent of the agreement. NAMIC is not so optimistic. We believe we can only rely on the language in the four corners of the document, and that language is not encouraging.

Reinsurance Collateral

The section of the covered agreement dealing with reinsurance collateral states that no EU reinsurer, meeting all other requirements to do business in the U.S., can be required to post collateral in the U.S. If the states do not adopt laws reflecting this zero-collateral requirement within five years, the covered agreement allows the federal government to pre-empt those state laws which remain in conflict.

Of course, this change will negatively impact insurers, both small and large in the U.S. as these companies are no longer guaranteed the collateral that EU reinsurers must hold in the U.S. to assure prompt payment of reinsurance claims. This collateral is critical to assure the collectability of U.S. judgments. Reinsurance payments help insurers timely pay the money owed to policyholders in the event of natural catastrophes or other large loss events. The elimination of required collateral particularly disadvantages smaller insurers which are more reliant on reinsurance. And though the agreement provides no prohibition on negotiating for collateral in reinsurance contracts, the small insurance companies will not have the same negotiating power as larger companies.

With the elimination of reinsurance collateral, state regulators have already proposed to eliminate credit to the companies for the purchase of reinsurance. Instead they would replace the lost reinsurance collateral by creating new obligations for the ceding companies in an enhanced capital requirement. This would fundamentally alter the way all U.S. insurance companies deal with capital requirements.

We do not dispute some potential benefit from the resolution of the reinsurance issues between the U.S. and the EU. However even those benefits are exaggerated and in many cases impacted by exceptions and ambiguous language.

First, there is a claim that the elimination of collateral requirements could result in lower reinsurance premiums. Premiums are affected by market cycles and currently the soft market driven by a flood of new capital is causing prices to go down particularly in the property catastrophe reinsurance market. In addition, the enactment of the NAIC's model law in many states and the collateral reduction that resulted may have already contributed to lower prices. Second, there are provisions which increase the requirements applicable to the EU reinsurers for ensuring payment of claims owed and enforcing judgments in the U.S. These are positive provisions, but would be unnecessary if not for the covered agreement removing the collateral requirement. Finally, the EU supervisors can no longer require U.S. groups doing business in EU member states to have a "local presence" in the country unless they have a similar requirement for their domestic (re)insurers. While U.S. (re)insurers are considering this an important concession, this is only an advantage for U.S. groups doing business in the EU if the EU supervisor does not currently have, nor decides to add, a similar requirement for the domestic EU companies. In addition, it is important to note that if the

agreement fails or terminates, it would be much easier to undo forbearance of these local presence demands of of EU supervisors than to repeal new state laws/regulations eliminating reinsurance collateral. **This is not an equal trade for U.S. insurers**.

The EU is unlikely to be the last jurisdiction to push for zero-collateral requirements as Bermuda has already asked whether the U.S. will give them the benefit of the same deal. This could be the beginning of zero collateral for all non-U.S. reinsurers. This would ignore the work state regulators/legislatures have done in the last several years in adopting changes to the NAIC's Credit for Reinsurance Model Act and Regulation. The state policymakers enacting these laws have considered the issues, listened to interested parties, and developed solutions that balance the interests of foreign reinsurers, the U.S. primary insurers that are their customers, and the policyholders of U.S. companies who expect their claims to be paid. The process has been methodical and transparent and the issues fairly and openly debated, unlike anything about the covered agreement. Thirty-five states have already acted to enact this new NAIC model and those remaining states need to enact the revised model before 2019 to retain their NAIC accreditation.

Group Supervision

The covered agreement also addresses group supervision and group capital requirements. This issue was added to the covered agreement by U.S. Treasury with the idea that the U.S. would gain acceptance of the U.S. existing system of group supervision in exchange for giving up reinsurance collateral. Observers and interested parties were expecting simple recognition of the supervision provided in the model holding company act adopted and enforced in all states.

Instead, the agreement provides that the EU will allow U.S. insurance regulators to provide group supervision for their own domestic insurance groups that do business internationally. But, the EU doesn't recognize this right for parts of U.S. holding companies based in the EU or any of the affiliates of that EU-based group anywhere in the world. The EU also does not recognize this right for any U.S. holding company with a depository institution or that has been designated a Systemically Important Financial Institution (SIFI) or Global Systemically Important Insurer (G-SII). Nor does the agreement recognize this right if at any time they feel the insolvency of one of these U.S. companies could harm EU policyholders or threaten the EU economy. Finally, even if the U.S. provides supervision the EU maintains the right to ask for "information" for purposes of prudential group supervision that is "deemed necessary" by the EU supervisor to protect against serious harm to policyholders or financial stability. This sounds as though EU regulators can apply Solvency II reporting requirements at their discretion.

In concept, this group supervision provision is what U.S.-based insurers doing business in the EU need to avoid punitive regulatory requirements from EU supervisors. However, once the U.S. meets all its obligations under the agreement, and all the exceptions to the "recognition" of group supervision are considered, there is no language requiring that the EU will treat the U.S. as a "mutually recognized" or "equivalent" jurisdiction under Solvency II. Under this agreement, the U.S. will be taking actions at the state level that will be very difficult to reverse, without any guarantee that

at the end of five years the EU would continue to recognize the U.S. insurance regulatory structure as permanently mutual or equivalent. Allowing U.S.-based insurers to continue operating in the EU without regulatory penalty is nothing more than a return to the pre-Solvency II status quo. Even by the standards laid out by USTR and the FIO, this provision is a failure.

Of perhaps the greatest concern for all U.S.-based insurance groups (internationally active or not) is that the covered agreement seems to require U.S. states to enact provisions that are at odds with the U.S. legal entity system of regulation, specifically a group capital requirement. If these group capital standards are not adopted, the EU will not live up to its side of the agreement, but if they are adopted, it will impact even those companies not doing business in the EU.

Article 4(h) requires the U.S. to impose a group capital assessment that sounds similar to an NAIC project underway to develop a group capital calculation that has specifically been designed as a tool for supervision, not a capital requirement. However, the covered agreement anticipates a calculation that is more than an assessment tool. It must apply to the complete “worldwide parent undertaking” and ***must include corrective/preventive measures, up to and including capital measures***. It appears that the intention is to include the power to require increases in capital, capital movement between affiliates, or other fungibility mandates. Implementation of this kind of group capital standard will shift the U.S. away from a legal entity regulatory system and toward an EU-style group supervision system. ***Capital additions and new requirements will affect the affordability and availability of new insurance products and are not in the best interests of consumers.***

As noted these capital requirements would apply to the “world-wide undertaking parent” or the entire conglomerate that holds an insurance company – even entities completely removed from the insurance and financial sectors. This scope of capital is not even required under Solvency II, is broader than the scope of the current IAIS group capital standard, and conflicts with common sense. Insurance regulators should not be assessing the risk of manufacturing affiliates, telecommunication companies, and hotels held by a conglomerate just because they also hold an insurance company. This is, rightfully, outside their authority.

It is not clear that it was the intention of the parties to apply the covered agreement preemption authority to the group supervision provisions. However, the plain language of the agreement (Article 9) suggests it is not limited to the reinsurance article of the agreement. The Dodd-Frank Act states that the Director may only apply preemption to a state law that:

> “(A) results in less favorable treatment of a non-United States insurer domiciled in a foreign jurisdiction that is subject to a covered agreement than a United States insurer domiciled, licensed, or otherwise admitted in that State; and (B) is inconsistent with a covered agreement.” (31 USCS §313(f)(1)(A) and (B))

Some interpretations provide that this language limits application only to the reinsurance requirements. But there is concern that the EU may expect the groupwide supervision

language in the 2014 NAIC Holding Company Model Act to be adopted in every state. If that is the expectation, it could lead to a nullification of this agreement down the road – after the U.S. has already enacted difficult to reverse changes to state insurance law and regulation.

Process Concerns

NAMIC has serious concerns both about how the current covered agreement was negotiated, and how the process will work going forward. Negotiations with the EU were conducted in closed, confidential meetings, between the EU Commission, USTR, and the FIO. State insurance regulators were relegated to a minimal role, though these negotiations directly and significantly impact state laws and regulations. In the letter announcing negotiations both USTR and the FIO stated that "State insurance regulators will have a meaningful role during the covered agreement negotiating process."[2] Both offices clearly failed in this commitment – only a small group of state regulators were included in the process as mere observers and were subject to strict confidentiality with no ability to consult fellow regulators or the broader community of stakeholders.

Going forward, we are concerned about the creation of a standing "joint committee" composed of unnamed EU and U.S. representatives to oversee both implementation and the amendment of the current agreement. There may be some benefit from having a formal committee to help address disputes among the parties regarding the agreement. However, the joint committee creation and required meetings once or twice a year add to the perception that this is intended to be an on-going evaluative process with the EU and U.S. federal authorities telling state regulators whether they are doing their jobs well enough to meet federal and EU standards. The amendment process built into the agreement also conceivably allows federal and EU authorities to alter the terms in such a way that could also lead to further preemption of state law. And these amendments could be made without entering into a "new" covered agreement, bypassing the transparency provisions like the 90-day lay-over period put in place in Dodd-Frank. The prospect of endless renegotiation with the EU with little in the way of transparency should be worrisome to all.

Conclusion

The letter announcing the commencement of negotiations with the EU, clearly stated that "Treasury and USTR will not enter into a covered agreement with the EU unless the terms of that agreement are beneficial to the United States."[3] NAMIC does not believe that the offices met this criterion. Overall, the deal is a bad one for the vast majority of U.S. insurers which do not have operations in Europe and which get nothing from the agreement other than increased costs and new regulatory uncertainty. It is also a bad deal for consumers in America who ultimately pay for all of the additional costs associated with EU-style regulation being imported to the United States.

The covered agreement is an invented solution to an invented problem – the question of European regulators deeming our regulatory system equivalent. Again, to be clear,

[2] Ibid.
[3] Ibid.

those companies that are being threatened by increase regulatory burdens by EU regulators need relief and the U.S. should find a way to provide them with that relief. However, it is our view that the U.S. can and should explore other ways to address the unjustifiable trade barriers which the EU seems intent on throwing in the way of our domestic insurers attempting to do business overseas. That might include recourse through existing enforcement tools available in trade agreements, or it might involve negotiating a mutual recognition provision in a future trade agreement. NAMIC believes that the U.S. ought to be able to move the EU to take non-equivalent determinations off the table so that our insurance and reinsurance markets can continue to function without unfair barriers to trade.

In the end, Congress should urge the Trump Administration to go back to the drawing board and secure a better deal. A new solution is needed that meets the needs of the insurance-buying public, the insurance industry, and state regulators. NAMIC appreciates the opportunity to testify and looks forward to working with the committee going forward.