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GLOBAL INSURANCE INDUSTRY
YEAR IN REVIEW **2020**

EXCERPT

States Begin Revising Credit for Reinsurance Laws to Follow the New NAIC Models

During 2020, US jurisdictions began revising their laws and regulations governing credit for reinsurance to implement the amendments to the National Association of Insurance Commissioners Credit for Reinsurance Model Law and Model Regulation (the "**NAIC Models**") that were adopted by the National Association of Insurance Commissioners ("**NAIC**") on August 6, 2019. Those amendments were designed to satisfy the requirements of (i) the bilateral agreement on insurance and reinsurance between the US and the European Union; and (ii) a substantially similar bilateral agreement between the US and the UK (together, the "**Covered Agreements**").

Background of the Covered Agreements

In contrast to primary insurance, where an insurer generally needs to be licensed in a state in order to do business in the state, a reinsurer does not need to be licensed in a state in order to provide reinsurance to insurers in the state. However, if the reinsurer is not licensed in the state, then certain requirements need to be fulfilled in order for the US insurer purchasing the reinsurance (the "**ceding insurer**") to receive credit for the reinsurance on its balance sheet. Traditionally, an unlicensed reinsurer was required to post collateral for 100% of its reinsurance obligations, but that requirement has been relaxed over time as a result of a series of amendments to the NAIC Models, which have created avenues for some qualifying reinsurers to reduce or even eliminate this collateral requirement. Another important development was the enactment of the Nonadmitted and Reinsurance Reform Act of 2010 as part of the Dodd-Frank Wall Street Reform and Consumer Protection Act ("**Dodd-Frank**"), which provided that credit for reinsurance is determined solely by the state of domicile of the ceding insurer.

In 2011, the NAIC Models were amended so that reinsurers that have completed a prescribed process to become "certified" reinsurers can post significantly less than 100% collateral to secure their US reinsurance obligations. Under the 2011 amendments, 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 process to evaluate jurisdictions' oversight of reinsurers, under which it has designated seven non-US jurisdictions as "qualified jurisdictions" for this purpose (Bermuda, France, Germany, Ireland, Japan, Switzerland and the UK). The NAIC has also established a peer review system to oversee the certification of non-US reinsurers by states, which enables non-US reinsurers that become certified in one state to "passport" that certification throughout the US.

Dodd-Frank also established the legal framework for the US to enter into bilateral or multilateral "covered agreements" with foreign jurisdictions that address regulatory measures with respect to the business of insurance or reinsurance. If state laws are inconsistent with a covered agreement and provide less favorable treatment to non-US insurers or reinsurers than US companies, then the covered agreement will preempt state law. A covered agreement can serve as a basis for preemption of state law only if the agreement relates to measures substantially equivalent to the protections afforded consumers under state law.

Adoption of the Covered Agreements

The US-EU covered agreement, signed on September 22, 2017, by the US Department of the Treasury ("**Treasury**"), the Office of the US Trade Representative ("**USTR**") and the EU, requires US states to eliminate reinsurance collateral requirements for EU reinsurers that satisfy certain stipulated qualifications within five years, or else the Dodd-Frank preemption provisions will come into effect. In exchange, the EU will not impose local presence requirements on US insurers and reinsurers operating in the EU and, in effect, must defer to US group capital regulation for US entities of EU-based insurers and reinsurers.

On December 19, 2018, in anticipation of Brexit, the Treasury, the USTR and the UK signed a UK-specific Covered Agreement. The motivation for the US-UK Covered Agreement was to ensure that the arrangements embodied in the US-EU Covered Agreement would apply to the US-UK relationship after the UK ceased to be a member of the EU. The US-UK Covered Agreement effectively replicates the terms of the US-EU Covered Agreement.

The Covered Agreements eliminate local presence and collateral requirements for qualified US reinsurers operating in the UK and EU insurance markets. The Covered Agreements also eliminate the requirement for collateral for qualified UK and EU reinsurers operating in the US insurance market as a condition for their US ceding insurers to take credit for reinsurance. In addition, if US states implement appropriate group capital standards, the Covered Agreements provide that US insurance groups operating in the UK and EU will be supervised, at the worldwide group level, only by their relevant US insurance supervisors. Conversely, UK and EU insurers operating in the US will be supervised at the worldwide group level only by their relevant UK and EU insurance supervisors.

Broadly speaking, the Covered Agreements:

- Eliminate, as a requirement for reinsurance placement or as a condition for receiving financial statement credit for reinsurance, requirements for reinsurers based in the other jurisdiction to have a local presence or to post collateral;
- Provide that an insurance or reinsurance group will be subjected to worldwide group supervision only in its "home" jurisdiction—not in its "host" jurisdictions where it operates; and
- Establish regulatory best practices to be encouraged for cooperative exchanges of information among regulators across jurisdictions.

In order to obtain the benefits of the Covered Agreements, a non-US reinsurer must meet a number of requirements, including, among other things, maintaining a minimum capital and surplus of at least $250 million, meeting certain minimum solvency or capital ratios, adhering to prompt claims payment standards and furnishing certain financial information to the ceding insurer's domiciliary regulator upon request.

The Process of Amending State Laws to Conform to the Covered Agreements

The NAIC quickly recognized that it would need to amend the NAIC Models to dovetail with the Covered Agreements. Originally, those amendments were expected to be adopted in December of 2018, but adoption was delayed because the Treasury had expressed concerns about certain provisions that granted state insurance regulators discretion that could result in reinsurance collateral requirements that were inconsistent with the Covered Agreements. Accordingly, in early 2019, the NAIC Reinsurance (E) Task Force made revisions to the proposed amendments to address the Treasury's concerns, and the revised text of the amendments was adopted in June 2019.

One of the most important features of the 2019 amendments to the NAIC Models is the concept of a "reciprocal jurisdiction." The 2019 amendments define three categories of reciprocal jurisdictions:

- Jurisdictions with which the US has entered into a covered agreement (currently the EU and the UK);
- US jurisdictions that meet the requirements for accreditation under the NAIC financial standards and accreditation program; and
- Qualified non-US jurisdictions that have agreed to mutual recognition and reciprocity conditions that mirror those in the Covered Agreement (currently Bermuda, Japan and Switzerland).

Under the 2019 amendments, the benefits of the Covered Agreements are extended to all reinsurers domiciled in a reciprocal jurisdiction—not just to EU and UK reinsurers—provided that the reinsurers meet the capital and other standards required by the Covered Agreements and the NAIC Models.

Unfortunately, the COVID-19 pandemic has slowed the process of enacting the 2019 amendments across the states. While a modest number of state legislatures adopted the amendments during 2020, legislative attention in most states was preoccupied with the pandemic. However, it is hoped that a significant number of states will adopt the amendments to the NAIC models during 2021. The NAIC Reinsurance (E) Task Force has been tracking the progress of state adoption of the amendments at its web page.

Notably, the five-year deadlines imposed by the Covered Agreements remain in force. The Director of the Federal Insurance Office ("**FIO**") will begin evaluating US state insurance laws and regulations for possible federal preemption by March 1, 2021, making those states with the highest volume of gross ceded reinsurance a priority. The FIO Director will complete any necessary preemption determinations by September 1, 2022. Under the shadow of that deadline, the amended NAIC Models have been designated as NAIC state accreditation standards effective September 1, 2022. As a result, states that fail to amend their laws and regulations by January 1, 2023, to comport with the amended NAIC Models will risk losing their NAIC accreditation.

While it is likely that this prospect, together with the possibility of federal preemption, will motivate states to take the necessary steps to adopt the amended NAIC Models, the continuing impact of the pandemic, together with crowded state legislative agendas, may make actually achieving that goal difficult to achieve.

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