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EXAMINING THE U.S.–EU COVERED AGREEMENT

HEARING

BEFORE THE

COMMITTEE ON
BANKING, HOUSING, AND URBAN AFFAIRS
UNITED STATES SENATE

ONE HUNDRED FIFTEENTH CONGRESS

FIRST SESSION

ON

EXAMINING THE U.S.–EU COVERED AGREEMENT TO GATHER THE PERSPECTIVES OF THE PARTIES INVOLVED WITH CRAFTING OR WHO ARE AFFECTED BY THE COVERED AGREEMENT

MAY 2, 2017

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C O N T E N T S

TUESDAY, MAY 2, 2017

EXAMINING THE U.S.–EU COVERED AGREEMENT

TUESDAY, MAY 2, 2017

U.S. SENATE,
COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS,
Washington, DC.

The Committee met at 10:02 a.m., in room SD–538, Dirksen Senate Office Building, Hon. Mike Crapo, Chairman of the Committee, presiding.

OPENING STATEMENT OF CHAIRMAN MIKE CRAPO

Chairman CRAPO. This hearing will come to order.

Today we are joined by a panel of witnesses who will provide the Committee with a comprehensive discussion of the U.S.–EU Covered Agreement. These witnesses represent a broad range of views on the agreement, including companies in support and in opposition.

We will also hear from the lead negotiator of the Covered Agreement, a representative of State insurance commissioners, and, finally, an independent expert specializing in international financial regulation.

In the United States, a State-based model for insurance regulation has been the preferred standard for over 100 years and was solidified with the passing of McCarran–Ferguson in 1945. With an ever-increasing globalization of insurance and reinsurance services, it is healthy to examine and debate how the American model fits within the global regulatory framework.

Title V of the Dodd–Frank Act authorized the Federal Insurance Office, within the Department of Treasury, and the U.S. Trade Representative to enter into "covered agreements" with foreign jurisdictions regarding prudential regulation of insurance and reinsurance.

In November 2015, this Committee was notified that the United States planned to begin negotiations with the EU on a covered agreement. In notifying Congress, the Obama administration laid out several priorities it hoped to achieve from the negotiations, including equivalence for U.S. insurers with respect to Solvency II and gaining EU recognition of the U.S. insurance regulatory framework.

In January, this Committee was presented with a final Covered Agreement negotiated between the United States and the European Union. The Covered Agreement represents more than a year of negotiations on many complex, cross-border regulatory issues. The terms of the agreement address three main areas of prudential insurance supervision: reinsurance, group supervision, and information sharing.

I look forward to engaging with our witnesses on a number of important questions.

First, I would like to better understand the implications for the U.S. insurers and the State insurance commissioners on the removal of reinsurance collateral requirements.

Second, what benefits will U.S.-based, internationally active insurance and reinsurance companies receive from the agreement?

Third, what are the implications of the group supervision and group capital requirements for our U.S. regulatory framework?

And, finally, if an exchange of letters is necessary to clarify the agreement, what are the items that must be addressed, and can the items be addressed without reopening the agreement?

As a new Administration undertakes its review of the Covered Agreement and Congress provides input, these are some foundational questions that must be addressed.

Senator Brown.

STATEMENT OF SENATOR SHERROD BROWN

Senator BROWN. Thank you, Mr. Chairman, for holding today's hearing. Thanks to the witnesses for your testimony. It is good to meet you all.

Our State-based insurance system is unique, as we know, throughout the world. It has largely served us well. We should fight to maintain it, including by rejecting efforts to impose the Solvency II accord, Europe's insurance capital rules, on our insurers. At the same time, it means that companies that want to operate internationally face challenges. We need a system that works, too, for them.

The financial crisis of several years ago, almost a decade ago, showed there were shortcomings in the consolidated supervision of international insurance conglomerates. Since the crisis, State insurance regulators have worked on proposals to develop comprehensive supervision and capital frameworks for insurance companies. While some progress has been made, there is clearly much to be done.

At the Federal level, the Federal Reserve's work on both fronts has been encouraging. It has proposed a useful group capital framework for the insurers that it supervises. It has developed consolidated governance and risk management standards for systemically important insurers.

Turning to the Covered Agreement that we are here to discuss, as a single entity that speaks on behalf of the U.S. on insurance matters, I believe that the Federal Insurance Office, Mr. McRaith in particular, has served a valuable role. This agreement offers U.S. and EU reinsurers alike relief from both requirements to have a local presence and local collateral. It is not a small consideration when EU countries like Germany have put our companies on notice to set up physical locations, which surely is a significant cost to U.S. companies. It also establishes certainty about when U.S. standards will qualify as equivalent under Solvency II for U.S. insurers, preventing Europe from imposing its rules on our companies, if not permanently at least for 5 years. To the extent that there is some disagreements on the meaning of terms in the agreement, particularly as they relate to capital, I hope today's hearings will offer an opportunity to clarify those terms. If there are concerns about the level of transparency and consultation in this and other international negotiations, that is certainly a matter that should be debated, including whether any reasonable reforms are necessary.

Let me close with two concerns that I have.

First, I am concerned by efforts to hamstring or eliminate FIO. Eliminating an important voice domestically and internationally on insurance regulations, handing these negotiations over to the U.S. Trade Rep who lacks insurance expertise would be a step in the wrong direction.

Second, I do not think the answer to discontent with the process of some of these international financial discussions is to include financial regulations in future free trade agreements. Former Treasury Secretary Lew said that watering down in any way U.S. regulatory standards is not appropriate in trade agreements, and I think there is a resounding emphasis that we all have on that. He said the U.S. should call on the world community in appropriate settings like the G–20 and the Financial Stability Board "to try to drive that race to the top," his words, instead of the other way, mine.

We should push other countries to raise standards, not engage in a race to the bottom, as so many of these free trade agreements do and have done. I am skeptical that the answer to concerns about transparency in insurance agreements is to replace them with a trade negotiation process where corporate CEOs often have better access to information about trade negotiations than the American people's elected representative, a significant problem over the last 2 or 3 years during the negotiations of the Trans-Pacific Partnership.

So, again, I thank the Chairman for holding this hearing, and I look forward to hearing from our witnesses.

Chairman CRAPO. Thank you, Senator Brown.

As we go to our witnesses today, first we will receive testimony from Michael McRaith, former Director of the Federal Insurance Office at the U.S. Department of Treasury.

Second, we will hear from Commissioner Julie Mix McPeak of the Tennessee Department of Commerce and Insurance, on behalf of the National Association of Insurance Commissioners.

Next we will hear from Michael Sapnar, CEO of Transatlantic Reinsurance, on behalf of the American Insurance Association, the American Council of Life Insurers, and the Reinsurance Association of America.

Then we will hear from Stuart Henderson, CEO of Western National Mutual Insurance Company, on behalf of the National Association of Mutual Insurance Companies.

And, finally, we will hear from David Zaring, associate professor of legal studies at the Wharton School at the University of Pennsylvania.

As we move to our witnesses, I want to remind our Senators that when we go to questions, we will hold ourselves to our 5-minute limit. Sometimes Senators want to move that up a little bit.

And to the witnesses, that may happen at the end of the 5 minutes of the Senator. I encourage you, when that happens, to try to keep your responses as brief as possible so we can let every Senator have an opportunity for questions.

To the witnesses, also, you have been asked to keep your verbal remarks to 5 minutes. You will have many opportunities to add to and supplement them, and your written testimony has been made a part of the record.

With that, let us begin. Mr. McRaith.

STATEMENT OF MICHAEL T. MCRAITH, FORMER DIRECTOR, FEDERAL INSURANCE OFFICE, DEPARTMENT OF THE TREASURY

Mr. MCRAITH. Chairman Crapo, Ranking Member Brown, Members of the Committee, thank you for inviting me to testify. I appear on my own behalf today as the former Director of the Federal Insurance Office at Treasury and as Treasury's lead negotiator for the Covered Agreement.

First, thanks to Commissioner McPeak and her colleagues for the integral role they played in the negotiation. We created an unprecedented mechanism for State regulators to join our delegation, and they attended and participated in person in every negotiation except the final one in Brussels when they joined by telephone.

Through a confidential web portal, State regulators received every EU document shortly after it arrived. Before any U.S. document was sent to the EU, we shared it with the States and then held a conference call to receive their input. State regulators were an essential part of our negotiating delegation.

The prudential issues addressed by the agreement are not new. Reinsurance collateral reform and Solvency II implications have long been discussed in the United States. The agreement brings closure to these issues.

The States have undertaken to reform reinsurance collateral requirements, reform that benefits EU reinsurers, and in exchange, the States receive nothing of benefit for the U.S. industry operating in the EU. Nothing.

Through the agreement, U.S. reinsurers will now have access to the entire EU market on the same terms as EU reinsurers operating in the U.S. For U.S. insurer groups, the agreement caps the application of Solvency II to the EU operations of U.S. insurers. The agreement affirms that the U.S. supervises its insurance sector as the U.S. deems appropriate. This saves our insurers potentially billions of dollars, preserving American jobs and benefiting U.S. industry and consumers.

States have been developing a group capital calculation for more than 2 years. The agreement, which applies only to those insurers operating both in the EU and the U.S., does not prescribe the content or the manner of that calculation. The agreement endorses what the States do or, in the case of group capital, what they have publicly committed to do, and gives them 5 years to do it.

The agreement is cross-conditional. Neither the EU nor the U.S. receive the benefits of the agreement without satisfying the conditions. And if a question arises, the agreement provides a resolution mechanism. If all conditions are satisfied within the 5-year period, then the terms of the agreement become permanent.

In 2016, U.S. reinsurers lost existing business in the EU and opportunities for new business. In 2016, U.S. primary insurers operated with uncertainty about treatment by their EU supervisors, including whether they would be required to establish multiple subsidiaries.

We entered into negotiations seeking to improve the rigor, uniformity, and consumer protections of U.S. reinsurance oversight. We sought to include State regulators in a manner without precedent in American history. We achieved these goals.

We sought to remove excessive regulation that neither protected consumers nor supported industry. We sought to ensure that U.S. industry operated in the EU on a level playing field. We achieved these goals, saving our industry potentially billions of dollars. While providing equal benefits to the EU, this Covered Agreement puts America first.

Now, our diverse insurance sector will always include skeptics. Some opponents might complain about a projected hypothetical concern in 5 years as if just one more piece of writing is necessary, even when that writing would entirely duplicate what is already in the agreement. But this is not the time for the predictable insurance debate about statutory prerogatives or who does what. This is not a theoretical discussion about conceptual international standards of zero effect in the U.S.

This agreement answers real-time questions about the allocation of capital by U.S. insurers, about business opportunities for U.S. insurers and reinsurers, and whether U.S. industry operating in the EU employs more Americans or fewer. Will U.S. industry grow or will it be stifled?

Now is the time to show American leadership, to skip the usual insurance script, and to endorse this resolution of a real-time threat to U.S. insurers' growth and to insurance jobs in States around our country. Now is the time to solve a real problem, and this agreement does just that.

Thank you for your attention. I look forward to your questions.

Chairman CRAPO. Thank you. And before we move to Ms. McPeak, I should indicate some of you may notice that the room is a little bit unusually warm. If you are feeling that, it is not necessarily because you are nervous. It actually is a little bit too warm in here. We are trying to get that fixed, and we apologize.

Ms. McPeak, please proceed.

STATEMENT OF JULIE MIX MCPEAK, COMMISSIONER, TENNESSEE DEPARTMENT OF COMMERCE AND INSURANCE, ON BEHALF OF THE NATIONAL ASSOCIATION OF INSURANCE COMMISSIONERS

Ms. MCPEAK. Thank you, Chairman Crapo, Ranking Member Brown, and Members of the Committee. I appreciate the opportunity to testify today on behalf of State insurance regulators.

My written testimony details the NAIC's concerns with the EU Solvency II regime and its equivalence process, our historical dialogs with the EU to resolve the issue, and the subsequent negotiations of a potentially preemptive Covered Agreement. While we take serious issue with the lack of meaningful involvement in those negotiations and believe there are lessons to be learned going forward, my testimony today will center on the agreement's substance.

The focus from supporters has been on the perceived benefits of the agreement for the subset of U.S. firms doing business in the EU. However, as Congress and the Administration weigh the merits of the agreement, consideration must be given to what is sacrificed.

With regards to reinsurance collateral, the NAIC has made great strides in addressing the EU's concerns. Thirty-nine States representing 70 percent of the market have adopted the NAIC model reducing collateral. To drive further adoption, the model becomes an accreditation requirement on January 1, 2019. Notwithstanding our progress, this agreement fully eliminates collateral requirements and does not include a fulsome evaluation of a reinsurer's creditworthiness.

Considering that significantly reduced collateral protections represent commitments to policyholders, wiping them out will force regulators to find other mechanisms with which to protect them and insurers from the risks posed by reinsurance counterparties.

Notably, the agreement contains several ambiguities that make it difficult to evaluate and implement. By way of example, it is unclear the extent to which regulators can even impose alternatives to collateral that address reinsurance counterparty risk. The agreement appears to supersede existing authority of regulators to obtain information currently authorized under State law. The agreement also requires a group capital assessment, but implies State insurance regulators must have authorities to remedy any deficiency with capital, even though other regulatory tools may be more appropriate.

All of the ambiguities would have to be resolved by an undefined joint committee composed of representatives of the U.S. and EU, with no mention of a role for State insurance regulators. If the joint committee cannot reach resolution, this agreement may be voided, thereby creating the real prospect of perpetual renegotiation and uncertainty for the U.S. insurance sector.

Earlier this year, Mr. McRaith testified to what he believed the agreement accomplished. Candidly, we were surprised. Notwithstanding our concerns with eliminating collateral, Mr. McRaith's characterization of the agreement, if shared by the present Treasury Department and, more importantly, by the EU, is more promising than a plain reading of the text suggests. As such, the focus of our request to Congress, Treasury, and the USTR has evolved to urge confirmation of some of these key assertions.

Last week, the NAIC submitted to Treasury and USTR a list of provisions to be clarified before the United States moves forward with implementation of the agreement. We urge the Administration to expeditiously provide the needed clarity of these provisions now rather than taking an imprudent leap of faith that differing interpretations will be worked out later through a joint committee.

Absent this, there is no assurance that State implementation will meet the terms of the agreement and satisfy the current Administration or the EU. That could put us in a position of changing State laws only to have the EU challenge compliance at a later date and revert to unfair treatment of U.S. companies. Under these circumstances, it is hard to see how our sector can achieve certainty and finality regarding their concerns. We simply want to ensure that all parties agree that we have the deal that we have been told that we have.

Confirmation can be achieved without renegotiation and without undue delay. Without clarification, it is entirely unacceptable to ask 50 State Governors, legislatures, and regulators to revise fundamental elements of our system based on the informal interpretations of a former Treasury official. Such confirmation of intent will also ensure that the EU will not be able to use the agreement's ambiguity as a means of imposing their regulatory system and ultimately their will on our insurance sector to the detriment of U.S. insurance companies and policyholders.

In conclusion, working together, we can obtain a level of comfort and clarity that will achieve finality and certainty for our sector without sacrificing consumer protections. As the States are the primary regulators of the insurance sector and it will be our responsibility to implement the provisions of the agreement, our involvement and buy-in is essential to its success. We have confidence that, through the bipartisan efforts of this Congress as well as commitment of this Administration, we can resolve the ambiguities and ensure that the U.S. obtains the best deal possible for our constituents.

Thank you again for the opportunity to share our views, and I am pleased to answer any of your questions.

Chairman CRAPO. Thank you very much.

Mr. Sapnar.

STATEMENT OF MICHAEL C. SAPNAR, PRESIDENT AND CHIEF EXECUTIVE OFFICER, TRANSATLANTIC REINSURANCE COMPANY, ON BEHALF OF THE AMERICAN INSURANCE ASSOCIATION, AMERICAN COUNCIL OF LIFE INSURERS, AND THE REINSURANCE ASSOCIATION OF AMERICA

Mr. SAPNAR. My name is Michael Sapnar, and I am president and CEO of Transatlantic Reinsurance Company. I am testifying today on behalf of my company, the RAA, the American Insurance Association, the American Council of Life Insurers, and the Council of Agents and Brokers. I am pleased to appear before you today to express our strong support for the Covered Agreement between the U.S. and the European Union. I commend Chairman Crapo and Ranking Member Brown for holding this important hearing and welcome the opportunity to address the Banking Committee.

We strongly support prompt signing of the Covered Agreement, which is consistent with our equally strong support for the State-based insurance regulatory system. The Covered Agreement is a targeted Federal tool that supplements the State-based system by dealing with important international regulatory issues that State regulators cannot constitutionally address. It does not create regulatory authority at the Federal level, and the limited preemption authority is narrowly targeted to the collateral issue.

I would like to make two main points today.

One, the Covered Agreement provides U.S. companies full access to the world's largest insurance market without having to establish a local presence or be subject to European regulation, capital, and governance standards.

Two, prompt signature is critical to full realization of the agreement's benefits, and any requests for clarification are unnecessary and may jeopardize the deal.

First, the Covered Agreement addresses multiple issues, many of which have been outstanding for years. It is a shrewd deal for the U.S. as we gain access through a mutual recognition approach without compromising our regulatory structure and by simply accelerating or formalizing initiatives around collateral and capital that State regulators have already begun to address.

One of the agreement's key attributes is the avoidance of applying the EU Solvency II insurance regulation and capital requirements to U.S. companies. In 2014, U.S. State regulators wisely decided not to seek Solvency II equivalence because of its inflexibility and the changes that would be required to the U.S. system, which has been proven. However, without this equivalence designation, U.S. reinsurers could only trade in the EU if they have a Solvency II-compliant branch in every country where the business is conducted or they have a subsidiary in a third country that has been deemed equivalent.

In 2012, I testified to the House Insurance Subcommittee about the issues and obstacles like equivalence that my company, TransRe, and our peers were encountering in the EU. Since then, Transatlantic Re has been forced to move capital and jobs from the U.S. to the EU, has lost business in certain EU member countries, and has incurred significant additional compliance costs, all of which make us less competitive. The Covered Agreement, however, places us on equal footing. The agreement provides U.S. companies with the benefits of Solvency II equivalence without its requirements. U.S. companies get full access to the EU without having to establish a local presence and without being subjected to European group governance and capital standards.

Second, it is critical that the Administration promptly sign the Covered Agreement. Delaying signature could eliminate benefits U.S. companies receive under the agreement. EU countries are not currently enforcing Solvency II on U.S. companies in anticipation of signature of the agreement. For example, the German regulator is conditionally suspending its local presence requirements for U.S. reinsurers pending signature of the agreement. If the agreement is delayed or not finalized, they will apply the rules, perhaps retroactively, to U.S. companies.

In fact, without the Covered Agreement, U.S. reinsurers lost significant business at January 1, 2017, because of these local presence requirements. If the Covered Agreement is not signed, U.S. companies will not be able to renew much less write any new business in the EU without first creating branches in member States or subsidiaries in equivalent countries. These adjustments require time and relocation of capital and people from the United States, and they raise costs. It is imperative that U.S. companies and the EU market have timely certainty regarding U.S. companies' ability to write business in the EU when the renewal process begins in early September. Failure to act promptly will adversely affect U.S. companies' ability to acquire and retain business.

In addition, the Covered Agreement should not be delayed by requests for clarification or suggested improvements in the process. A few companies have requested a formal signed clarification of certain provisions before the agreement is signed. The joint committee in the agreement is intended to address the exact types of issues being raised. It is also likely that this clarification would be viewed as an attempt to renegotiate the agreement.

Finally, some of the objections seem to stem from process rather than product. However, this agreement was conducted in accordance with law, and no one has asserted otherwise.

In conclusion, the Covered Agreement is a narrowly tailored tool that solves real costly problems for U.S.-based companies while providing the first formal recognition of the strength of the State-based system. It is time to sign the agreement and begin the implementation process.

Thank you.

Chairman CRAPO. Thank you, Mr. Sapnar.

Mr. Henderson.

STATEMENT OF STUART HENDERSON, PRESIDENT AND CHIEF EXECUTIVE OFFICER, WESTERN NATIONAL MUTUAL INSURANCE COMPANY, ON BEHALF OF THE NATIONAL ASSOCIATION OF MUTUAL INSURANCE COMPANIES

Mr. HENDERSON. Good morning, Chairman Crapo, Ranking Member Brown, and Members of the Committee. Thank you for holding this important hearing.

My name is Stu Henderson. I am the president and CEO of Western National Insurance Group. Western National is a mutual company which has been serving policyholders since, well, over 115 years. Originally formed in St. Paul, we now operate as a regional insurance company serving individuals, families, and businesses all over the Midwest, Northwest, and southwestern U.S., plus Alaska.

I am here today on behalf of the National Association of Mutual Insurance Companies. NAMIC is the largest property/casualty insurance trade in the country, with 1,400 members representing nearly 40 percent of the U.S. market. I have had the privilege of serving as the association's chairman 2 years ago, and I have a deep appreciation for and understanding of its membership.

NAMIC also appreciates the Committee's focus on the recent U.S.–EU Covered Agreement. This bilateral agreement merits careful scrutiny to understand its impact on the U.S. domestic insurance industry and our policyholders.

Let me start by clarifying. Western National is a U.S.-only company. Just like the vast majority of the U.S. insurance industry, we do not operate internationally. However, we deal with international reinsurers all the time, and, in fact, I once worked for an international reinsurance company.

The implementation of Solvency II in 2016, the EU's new insurance regulatory system, has created heightened regulatory requirements for U.S. companies doing business in EU all because the U.S. has not been deemed equivalent under the EU's new system.

This has created a real and present difficulty for a relatively small number of U.S. insurers and reinsurers doing business in the U.S.

To summarize, under a new, untested, and unproven regulatory scheme, the EU, number one, granted itself the role of supreme arbiter of valid insurance regulation; two, decided that the 150-year-old U.S. system was inadequate and not good enough for them; and, three, proceeded to treat U.S. companies unfairly. All of a sudden, U.S. companies need heightened scrutiny at the group level and reinsurers need a local presence to continue doing business in the EU—all this after allowing those very same insurers to safely operate in Europe for decades. It would seem to me that the appropriate response to this would be for the U.S. Government to strenuously object and to demand the mutual recognition of our system of regulation. Instead, they have attempted to solve this narrow problem invented by the EU and in the process have created a whole new set of problems.

To obtain permanent recognition of the U.S. insurance regulatory system as mutual or equivalent, the FIO and USTR negotiated an agreement to eliminate requirements for those EU insurers to post collateral in the U.S. to meet their obligations. Even if we stipulate that the equivalence problem can only be addressed through a Covered Agreement and that forfeiting $40 billion of reinsurance collateral is necessary to solve it, the agreement fails on its own terms. There is no language anywhere in the Covered Agreement that confirms U.S. group supervision as mutually recognized or equivalent.

In exchange for the release of $40 billion of collateral, the EU has only agreed to return U.S. insurers to pre-Solvency II status, and there is no guarantee that this reprieve will continue at the end of the 5-year term. Uncertainty is the enemy of business and of good Government.

But the EU is not satisfied there. They successfully negotiated additional changes to the regulatory system. Specifically, the agreement requires a group capital standard for U.S.-based insurance companies. If that standard is not adopted, the EU will not live up to its side of the agreement. If it is adopted, it will impact those of the 94 percent of the 3,200 property/casualty companies in the U.S. who do not do business internationally such as Western National.

Section 4(h)(2) of the agreement clearly states that the new U.S. group capital standard must apply to worldwide parent undertaking and include corrective or preventive measures up to and including capital measures. This would mean increases in capital, movement of capital between affiliates, and/or fungibility mandates. This is plainly not a simple capital calculation, such as the NAIC has been contemplating for the U.S. In fact, this kind of group capital standard will shift the U.S. from a legal entity regulatory system protecting policyholders to an EU-style group supervision system designed to protect investors and creditors. This is not a win for U.S. policyholders whom we represent.

This agreement is bad for the vast majority of U.S. insurers who lose reinsurance collateral protection and get nothing but new requirements in return. We urge Congress to work with the Administration to resolve issues with the current agreement. While we cannot allow the EU to continue treating U.S. insurers operating there unfairly, this current deal costs U.S. companies only too much and falls short of obtaining mutual recognition of our regulatory system. At a minimum, we need to begin a process to formally clarify aspects of the agreement and, if necessary, the U.S. should not hesitate to go back to the drawing board and secure a better deal.

Again, thank you for the opportunity to speak here today. I look forward to answering your questions.

Chairman CRAPO. Thank you.

Mr. Zaring.

STATEMENT OF DAVID ZARING, ASSOCIATE PROFESSOR OF LEGAL STUDIES AND BUSINESS ETHICS, THE WHARTON SCHOOL, UNIVERSITY OF PENNSYLVANIA

Mr. ZARING. I am an associate professor of legal studies at the Wharton School, and I study international financial regulation there. It is a pleasure to be here today. I want to put the Covered Agreement in context, and in my testimony on the agreement between the United States and the European Union, I would like to focus on three points.

First—and this is the point on which I will spend the most time—the Covered Agreement grew out of an effort in the wake of the financial crisis to improve the regulation of financial companies, including insurance companies, given the repercussions of the failure of the large insurance company AIG during that crisis. For insurance, that effort has involved a number of different channels, and the goals have been twofold:

One has been to make sure that globally active insurance companies are sensibly regulated as whole enterprises rather than as a series of operating subsidiaries in a variety of different jurisdictions.

The second has been to ensure that internationally active insurance companies and reinsurance companies have faced a level playing field when it comes to doing business at home or overseas.

The Covered Agreement accompanies efforts to reduce nontariff barriers through trade agreements and efforts to increase the quality of global insurance supervision through organizations like the International Association of Insurance Supervisors. It offers the reduction of two barriers to trade and two regulatory agreements that will improve the supervision of insurance conglomerates in both the United States and Europe, serving objectives identified by regulators and trade negotiators in the wake of the financial crisis.

As a general matter, covered agreements are meant to serve as a bilateral backstop for regulatory cooperation in cases where multilateral regulation has not made progress. An analogy might be drawn to this country's approach to trade. When multilateral agreements like the Doha Round have foundered, the United States has increasingly looked to pursue its trade interests through regulatory cooperation or bilateral trade and investment deals.

In the case of post-crisis insurance supervision, the hope evinced in Dodd–Frank is that where multilateral efforts to either level the playing field or to improve the supervision of systemically risky insurance companies has foundered, bilateral covered agreements might serve as a useful supplement. It can stand in stead when the trade negotiations are not working or are not appropriate or when multilateral regulatory cooperation is going too slowly.

Second, the agreement deepens cooperation through an exchange of information, includes a deal that reduces trade barriers in both the United States and the European Union, and provides a sensible framework, in my view, for the supervision of insurance conglomerates and groups. As a matter of content, it is likely to be good for insurance companies and consumers. And, in addition, it rationalizes the supervision of insurance companies by looking at the totality of their operations, just as banking supervisors do when it comes to banking financial conglomerates.

Third, the critics of the transparency of the process in concluding the Covered Agreement are, in my view, misguided. The United States never hid the fact that it was engaging in negotiations with the European Union, and now that the result of those negotiations have been made public, the covered agreement is being appropriately reviewed by Congress, as it is in this hearing that we are all pleased to be at today, and by the stakeholders who are most likely to be affected by the agreement. That is the right way to conduct transparent international processes: congressional approval to engage in international negotiations is given beforehand, and the results of those negotiations are reviewed after the fact. Requiring more and different consultations during the negotiation would be both inconsistent with the way the negotiations work and I think entirely unnecessary process. I would also like to emphasize that the Covered Agreement itself provides for an elaborate panoply of procedural protections when it comes to the implementation of the accord, protections that I think will involve State insurers, State insurance regulators, and other stakeholders with a stake in the agreement.

More generally, international regulatory cooperation is not easy, and it must certainly be paired with procedural protections; but the United States cannot ignore the efforts and interests of foreign regulators when it thinks about its own position in international financial markets. The global effort to create a single common set of accounting standards exemplifies the risks of failing to engage. The United States largely stayed out of that process, but the resulting International Financial Reporting Standards have now been adopted by essentially every jurisdiction in the world except one. And the Securities and Exchange Commission is now accepting IFRS for foreign filers. This country can take a leadership role in devising international regulatory standards, or it can let others develop the standards and adopt them later. But it cannot ignore them.

Thank you, and I look forward to your questions.

Chairman CRAPO. Thank you very much, and I commend all of our witnesses for paying attention to the clock. That is truly appreciated.

I want to start out my questions with regard to the question of an exchange of letters. Obviously, from the testimony you can see here that there is some disagreement about whether there is adequate clarity in the agreement on certain issues.

Perhaps first I should ask you, Ms. McPeak, do you agree—I think I heard you say in your testimony that if the agreement means what it has been said to mean, you do not have as many concerns, but it is not that clear in the text of the agreement. Is that a fair estimate or statement of what you said?

Ms. MCPEAK. I think that is fair, Mr. Chairman. I believe that our members would not oppose the agreement if we could reach clarity on some of the ambiguities that we have provided through staff in a list to this Committee, actually.

Chairman CRAPO. And so you and some others, I think, or at least some have suggested that we have an exchange of letters, that the USTR and Treasury work to have an exchange of letters to provide clarity up front as to what the actual meaning of the terms of the agreement are.

Mr. McRaith, is that possible to do?

Mr. MCRAITH. Mr. Chairman, I am, as you know, no longer with the Treasury Department. I suppose anything is possible. I would express serious concern about that prospect. It is notable that those seeking clarity are also opponents of the agreement. What we see is the requests for clarification, particularly those from the NAIC, these are issues in which the NAIC directly participated. They were part of the conversation that generated the words on the page of the agreement that led to the understanding between the EU and the U.S.

With respect to the industry, there were two issues I have heard: One, what happens 5 years from now? Well, having a second document that repeats what is in the first document does not provide any clarity about what happens in 5 years. The other question is whether the reinsurance reforms would be retroactive based on the word "amendment," and it is basic Contract Law 101 that both parties have to agree to an amendment to a reinsurance contract. I do not think we need that clarification from the EU.

Chairman CRAPO. But are you saying that the words are clear?

Mr. MCRAITH. The agreement is clear on its face. The agreement, like any international agreement, may require interpretation and implementation clarity as things move forward. So once the agreement is signed, it is entirely natural and expected and a mechanism is established for the parties to coordinate and sort through any of these questions that might come up.

Chairman CRAPO. And, Ms. McPeak, would you respond on the question of whether your interests were adequately represented in the negotiations?

Ms. MCPEAK. Certainly. Well, we have been very instructive on the process, and I will say that six of us were included in the discussions, myself included, but we were not able to brief our colleagues or even consult with our individual general counsels in our Departments of Insurance.

But that process aside, the actual issue is the very public agreement that we have before us today is not clear on how to implement this on behalf of State insurance regulators. We do not know from the terms of the agreement itself whether we can impose additional consumer protection matters that might be substantially the same as reinsurance collateral because that might void the agreement. We do not know if our capital assessment tool is going to be sufficient to meet the terms of the agreement. And I think before we go forward with model laws and processes through State insurance regulators and our State legislatures, we need to know the rules of the road, and we need to know that our actions are going to be exactly what is contemplated in the agreement. And these issues should be worked out ahead of time.

Chairman CRAPO. Thank you. Both Mr. Henderson and Mr. Sapnar are asking to be heard. I have got 71 seconds, so if you could each take about 30 seconds, I would appreciate it.

Mr. SAPNAR. Sure. In my experience, contracts never read perfectly clear. We have a direction to go in. A bird in the hand is worth two in the bush, in my opinion. The joint committee is there to clarify or go through any issues. And we believe any delay will mean more lost business for U.S. companies trading abroad.

Chairman CRAPO. Thank you.

Mr. Henderson.

Mr. HENDERSON. The agreement is 24 pages long, and yet there is no words in it that we need to see which are the words that was the goal in the first place: mutually recognize the two systems. The whole agreement could probably be a page, lawyers aside, if it simply said mutually recognizing systems, and the other problems go away.

Chairman CRAPO. Well, thank you. And I think we will have an opportunity here to get back to this issue some more.

Senator Brown.

Senator BROWN. Thank you, Mr. Chairman.

Three years ago, Senator Collins and Senator Johanns and I worked to ensure the Federal Reserve should not subject U.S. insurers to the bank-like capital framework. You may remember that. I would likewise be concerned—and this question is for Mr. McRaith. I would likewise be concerned if Europe's bank-like Solvency II capital framework were forced upon U.S. insurers. Walk through with us, Mr. McRaith, the intent behind the provisions of the Covered Agreement that address capital rules for insurers, if you would.

Mr. MCRAITH. Sure. First, Senator, I want to acknowledge the great leadership by you and your colleagues to address that issue a couple years ago. It was important and essential for the insurance industry.

With respect to the agreement, that is the entire purpose and objective of the agreement, that in the United States our regulators at the State level will decide how to supervise U.S. insurance groups. So contrary to what I have heard from at least one witness today, the agreement is entirely clear that there are boundaries now drawn. The EU will supervise its companies at the group level as it determines appropriate. In the United States, through the States, whether capital, governance, reporting, solvency oversight, it is the United States and our system and structure—in your opening remarks, you mentioned your support for the State system. It is that system that will have the authority and the capacity, only that system that will decide how are U.S. groups to be supervised, including with respect to capital. That is the objective of the agreement, and that very clear distinction and bright line is articulated in Article 4 of the agreement.

Senator BROWN. Thank you.

Professor Zaring, two questions about FIO. First of all, do you think it serves a useful role both domestically and internationally?

And then as you explore that, if you would give us your interpretation of FIO's authority to preempt State capital rules.

Mr. ZARING. I think that FIO has served a critical role in making progress in what is increasingly a globalized insurance marketplace. And what it has done, in my view, are two very useful different things, at least two.

For starters, it served this important coordinative function in creating a forum through which a consistent and commonly held United States approach to international negotiations can be taken. And that has made progress in international affairs easier and meant that the United States is better represented when it goes to these global fora and making decisions about whether it should get involved or not.

It has also served a disciplining function when it monitors regulatory quality in the United States, and I think that is an independent and useful thing as well.

One thing that FIO does not have is the power to preempt State insurance laws, and there is nothing in this agreement that suggests anything otherwise to me. It cannot replace capital rules. It cannot replace the statewide system on supervision. Indeed, it depends on that system of supervision to make the American side of the agreement work.

The limited things that could happen under FIO I view more as a notification process. To the extent that there would be any preemption at all, it would be when a State and FIO were at loggerheads about a collateral requirement for reinsurance, an approach to reinsurance, and FIO then would be in a position where it would basically be forced to make very clear to the State that it cannot operate the reinsurance collateral provision that it has. And it would in the same way be notifying the European Union that in its view there is some portion of the agreement that is not being met.

Senator BROWN. Thank you.

Mr. Chairman, one motion. I ask unanimous consent to submit the statement of a company in my State, Cincinnati Financial, for the record of today's hearing.

Chairman CRAPO. Without objection.

Senator BROWN. Thank you.

Chairman CRAPO. Thank you.

Senator Shelby.

Senator SHELBY. Thank you.

If the Secretary of the Treasury signs the Covered Agreement, in what circumstances and in what ways will Federal requirements preempt previously negotiated State-based insurance regulations? Ms. McPeak.

Ms. MCPEAK. Thank you for the question, Senator. The preemption provisions are related to the reinsurance collateral article in the Covered Agreement, and so if States are unable to create a system that is compliant with the Covered Agreement, we would be looking at preemption of those State laws requiring reinsurance collateral.

But more problematic for us is that the uncertainty in the agreement, being it is a cross-conditional agreement, if we have an issue with compliance, even on the group supervision or group capital side, it could void the entire agreement, and we would be back in the same position that we are today.

So we are very concerned about preemption. We want to make sure that as States we can comply with the provisions as intended in the agreement to avoid that preemption. But equally concerning to us is the voiding of the agreement if we do not know the rules to comply with the group supervision and group capital provisions.

Senator SHELBY. Mr. Henderson, who are the winners and losers in this agreement? There are always winners and losers.

Mr. HENDERSON. Absolutely. Thank you. You are absolutely correct. The losers in this case—well, let me take the winners first because that is easy. It is the EU. They got their way in the agreement——

Senator SHELBY. The EU wins.

Mr. HENDERSON. And Mr. Sapnar does not have to open a local office like he does not want to. The losers in my mind are the NAIC, which is already working on its own fixing some of these things, and now their legs are cut out from under them. And companies like mine, if there really is a need for a group assessment, which is what is in the material, then my company has to look at capital differently. So that could raise our costs and, hence, costs to policyholders.

Most concerning, which I do not hear anyone talking about at all, is the significance of the collateral being gone, because basically this agreement simply says there is no collateral. If I can give you a quick example, a real-life——

Senator SHELBY. Explain what you mean.

Mr. HENDERSON. I will give you a real-life example. Last year— I have a customer called Coin-Tainer, and they actually wash coins and then put them in those little paper things that nobody uses anymore. They had a chemical fire at night, and it burned the place down. We paid $5 million to them to rebuild their business. However, I actually pay $500,000 of that. The other $4.5 million is split between three reinsurers, each of whom must pay me $1.5 million so I can get back to whole. Collateral ensures that they do that. Without the collateral, I cannot be sure that I will get that money. If that happens over and over and over again, then my capital will have to go up. That causes more expense to my operation and the policyholders will see higher rates.

Senator SHELBY. So that is a game changer for you.

Mr. HENDERSON. It is.

Senator SHELBY. And other people situated like you.

Mr. HENDERSON. Yes, sir.

Senator SHELBY. Historically, have the European insurance companies been better capitalized than the U.S. or vice versa?

Mr. HENDERSON. Well, I think the real difference——

Senator SHELBY. Differently, isn't it?

Mr. HENDERSON. The real difference, sir, is in their system. So capital is everything to them. So as long as you have the capital, they really do not pay a lot of attention to anything else. Whereas, in the U.S. what the NAIC does as a legal entity rule, they look at each company individually, what are their liabilities, what are their assets, what does their capital have to be? I think that is a much more reasoned approach. So they examine us constantly. We have seven companies in six States. All of them come and examine us every 3 to 5 years. They look at rates; they look at forms. They are doing a lot more regulatory-wise than the people system.

Senator SHELBY. All of us are consumers. We buy different forms of insurance, whether individuals, businesses, professionals, and so forth.

Ms. McPeak, you represent the Commissioners in the United States of America. We have regulated insurance at the State level for a long time. Do the consumers lose on this Covered Agreement, or who loses?

Ms. MCPEAK. Well, the NAIC would certainly have preferred our model to reduce reinsurance collateral on a reasoned, step-by-step approach rather than a wholesale elimination of reinsurance collateral. We do not know if we can continue to require the reporting from the European insurers that you were just requesting information about their level of capitalization under the terms of this agreement. So I think our insurance consumers could lose because we as insurance regulators are going to be looking for another way to protect consumers from that reinsurance counterparty risk. And, again, we do not know the extent of mechanisms that might be available to us under the terms of this agreement as it is written. And so we feel like we will need to be taking measures to protect insurance consumers from that reinsurance counterparty risk, but we do not know exactly what mechanisms would be acceptable under this agreement, and that is why we are asking for clarification.

Senator SHELBY. If there had been more transparency in the negotiations, could that have helped you a lot?

Ms. MCPEAK. Well, just clarification in the language and transparency with all of our colleagues, several of our members did not get to see the language of this agreement until it was public, and so that transparency certainly would have helped throughout the process.

Senator SHELBY. Thank you, Mr. Chairman.

Chairman CRAPO. Thank you.

Senator Rounds.

Senator ROUNDS. Thank you, Mr. Chairman

In my former life, I sold insurance at the regional level, and we did business with a lot of regional carriers who really, during the really tough times, they stayed with us. And some of the larger ones basically were not able to provide us the services that we needed where the regionals stuck around. So I come with that as a background on it.

But I also know that they definitely need reinsurance and access to reinsurance markets, and it is a major part of their costs as well.

But I was just curious, and I want to give a couple of you an opportunity to clarify just a little bit. Ms. McPeak, former Director McRaith has just stated that the insurance commissioners were involved in the negotiation process basically at historic and unprecedented levels. You have indicated that there was a group of you that were there and participated in this, and yet, Director McRaith, you also indicated—and I just want to let you clarify first before I go to Ms. McPeak—that there is always the opportunity, the need to look at and to review and to update after the item has been adopted. That sounds kind of a lot like we went through here in 2009 when certain Members here actually promoted legislation that they had to pass in order to find out what was in it. That did not go over very well, and it continues to be an item of contention and a reminder to all of us.

Can you clarify a little bit about what you meant by that in terms of—you really did not mean sign it and then find out what is in it?

Mr. MCRAITH. Senator——

Senator ROUNDS. Or did you?

Mr. MCRAITH. No. We created an unprecedented historic mechanism to include officials appointed by Governors in most States in the negotiating delegation for an international agreement. These are individuals—and I was one, so I have great respect and affection for Julie and her colleagues and the work they do. But these are not—we were not policymakers at the State level. But we included the regulators in the negotiating delegation out of respect for and appreciation for and support for the role and primacy of the State regulators in oversight of insurance in the United States.

Now, my point is——

Senator ROUNDS. So you feel like you went above and beyond what would have been required.

Mr. MCRAITH. Far beyond what has ever happened in the history of our country. In addition, to answer your second question, the agreement is clear. But as any international agreement which covers, you know, thousands of potential fact patterns, there will be idiosyncratic questions that come up. Julie has raised a couple; Stuart, Mr. Henderson, raised a couple. These are things that can be addressed after the agreement is signed. To do that now imperils and would likely kill the entire arrangement.

Senator ROUNDS. It is interesting because it seems to me that if it might kill the entire arrangement, it would seem to be a pretty significant idiosyncratic question or comment.

May I go to Ms. McPeak just to follow up?

Ms. MCPEAK. I would agree with your comments. If the testimony by Mr. McRaith is, in fact, what has been intended by the parties all along, confirmation of that fact by current Treasury Department officials and the European Commission would not seem to be that difficult and would, in fact, be prudent and reasonable. If that is going to potentially damage the agreement in itself, it would indicate to me and to my colleagues as insurance regulators that perhaps we did not have a meeting of the minds to begin with. We are just asking for clarification before we begin implementation of this agreement.

Senator ROUNDS. Yes, sir, Mr. Henderson.

Mr. HENDERSON. It just occurs to me listening to this, naturally that is unprecedented and historic because it is the only one that has ever been done. So that adjective does not really mean much.

I believe that Mr. McRaith is an honorable man and he really thinks that is what it says. But when there are so many other honorable men and women who read it and do not think that is what it says, that is an ambiguity, and that is what has got to be clarified.

Senator ROUNDS. Yes, sir?

Mr. SAPNAR. As we heard, it took 10 years to get to this point, and as people change, we would not necessarily have the same people at the table. If you go back to discuss for clarification, there is a process set forth clearly in the agreement to resolve anything that people need more clarity on. I do not think there is a lot—in our opinion, it is a clear document.

Senator ROUNDS. You know, I am just going to go back here because it is exactly the follow-up that I wanted to do on Mr. McRaith, and I would like to come back just for a second. Could you tell me who will be representing the United States on the joint committee? It seems that there is a possibility—would State insurance commissioners be included in the joint committee?

Mr. MCRAITH. It is an excellent question, and we did not flesh out all the details of the joint committee in the agreement, but we——

Senator ROUNDS. It seems like that would be a pretty important one to find out.

Mr. MCRAITH. Well, we would absolutely—I would suggest and have said publicly other places that absolutely State regulators should be involved. Now, there is a question——

Senator ROUNDS. But it does not state in the joint committee who would be on it?

Mr. MCRAITH. But we also did not spell out what is a quorum. We did not spell out where the meetings should occur. We did not spell out whether there should be minutes maintained, whether there are votes on items. We did not spell out any of those things. But these are entirely natural, organic questions that we would expect to be answered reasonably, Senator, and as you would expect, in a conversation like this where the State regulators were included in the negotiating and drafting, we would, of course—I would expect they would be included in a joint committee. The question is which State commissioner. If it is an issue involved South Dakota, we would hope for the South Dakota commissioner. If it is an issue involving national policy, say, on reinsurance, we would want the representative from the States who leads their reinsurance work. If it involves a New York company or an Idaho company, we would want the Idaho or New York commissioner involved.

Senator ROUNDS. Thank you.

Mr. Chairman, my time has expired. Thank you.

Chairman CRAPO. Thank you.

Senator BROWN. Mr. Chairman?

Chairman CRAPO. Yes?

Senator BROWN. Yes, thank you. Before Senator Warren asks her questions, I have just one interjection. As has been established, the comment of Senator Rounds about Speaker Pelosi's comments about reading the health care bill have been proven as simply—has been taken out of context. No legislative leader would say, "I have got to find out what is in the bill. I have got to read it now that we have passed it," or however it is interpreted that she said it. The fact is there are 900,000 people in my State that have insurance now that did not have it before the Affordable Care Act, and I do not know why this place needs to continue to relitigate that, that the House is struggling, and nobody is reading any of those bills because they come so fast and furious. So let us just stick to what this issue is.

Thank you.

Senator ROUNDS. Well, Mr. Chairman, if I could respond. It is not intended to be derogatory. It is simply a matter that it is one thing that we most certainly do not want to have happen in here. Most of us, I think, we do not pass things to find out what is in——

Senator BROWN. Well, her comments were taken out of context, and we all know that, and it has been established. Let us focus on——

Senator ROUNDS. I thought they were pretty clear.

Senator BROWN. All right.

Chairman CRAPO. OK. So the debate on Obamacare will now return to——

[Laughter.]

Chairman CRAPO. ——covered agreements. Senator Warren.

Senator WARREN. All right. I am ready to rock and roll on this. So thank you, Mr. Chairman, I appreciate it. And thanks to you and the Ranking Member for holding this hearing.

So I have taken a look at the written testimony of all of the witnesses. I am very glad you are here today to talk about this. There are obviously a number of technical but important issues at stake in this agreement. But for me, this boils down to a pretty basic question. What will it mean for Americans who buy insurance, both individuals and companies, if this Covered Agreement is adopted and implemented? Or, on the flip side, what will it mean for policyholders if this agreement is abandoned?

I recognize that changing reinsurance collateral standards will not have a direct impact on policyholders, but I want to understand what the secondary effects might be.

Now, Mr. McRaith, you were the lead negotiator on this, so I thought maybe I would just start with you and then hear from everyone else. What is the ultimate policyholder impact here as you see it?

Mr. MCRAITH. Very clearly, U.S. companies that operate both in the EU and the U.S., primary insurers, people selling car insurance, home insurance, those companies will not have to add billions of dollars potentially in capital and compliance costs because of the EU regime. They will be able to use that capital to keep rates affordable, to offer better products to people on the coasts and elsewhere. They will be able to invest that capital in growth in other developing economies potentially or in new markets in the United States.

Senator WARREN. So you are basically saying a lower cost for insurers, and in a perfect market what that will mean is passed-along benefits to customers who either can buy at lower rates because there is more competition in the marketplace. Is that——

Mr. MCRAITH. That is a potential benefit to U.S. consumers, exactly.

Senator WARREN. OK. And downsides to consumers?

Mr. MCRAITH. So I have heard this concern about collateral, and I think some facts are important which we have not heard yet. As Commissioner McPeak mentioned, 39 States have adopted reinsurance collateral reform at the State level. That is fantastic progress.

This is going to become an accreditation standard in 2019, meaning every State has to adopt it.

When we surveyed the companies that have received relief under that reform, there were 31 published by the NAIC; 30 of those are posting 10 or 20 percent of the collateral they posted several years ago, so——

Senator WARREN. OK. And have prices——

Mr. MCRAITH. So it is not going from 100 to——

Senator WARREN. Have prices gone down for their customers?

Mr. MCRAITH. That is right, so it improves the—whether it affects consumers directly, as you know, there is the chain, reinsurer, insurer, consumer.

Senator WARREN. So there is no data yet to show that prices actually dropped?

Mr. MCRAITH. I think Mr. Sapnar could probably answer that question better than I.

Senator WARREN. OK. Ms. McPeak——

Mr. MCRAITH. But that would be the expectation.

Senator WARREN. OK, the expectation but no data.

Mr. MCRAITH. That is right.

Senator WARREN. Ms. McPeak.

Ms. MCPEAK. Thank you. I would disagree with my colleague Mr. McRaith. I would say that our States and our colleagues that have adopted the Credit for Reinsurance Model Act have reduced collateral requirements to 10 to 20 percent. This agreement is a wholesale removal of reinsurance collateral. We as regulators are going to be looking for consumer protection benefits through that counterparty reinsurance risk, and we will be trying to create other mechanisms to protect insurance consumers and our domestic companies that are purchasing reinsurance and no longer have collateral available.

The uncertainty surrounding the ambiguity in this agreement and what mechanisms will be available to us that are jurisdictionally agnostic add uncertainty to the market, and I think that increases prices to consumers.

Senator WARREN. OK. So you just say higher uncertainty, prices go up. All right.

Mr. Sapnar.

Mr. SAPNAR. Well, the trend of pricing for consumers over the last 5 years by almost any line of business in the United States has been favorable. It has been what we call a softening market, price declines, to the point where, in fact, they were not even covering lost costs in the automobile industry, which is now having an issue on the insurance side because the pricing was so cheap.

As far as collateral is concerned, nothing prevents people from still requesting collateral. It is just not regulatory mandated. There are hundreds of companies that post collateral without regulation, including my own.

Senator WARREN. I understand that. The question I am trying to ask is: If this were adopted or abandoned, what do you see is the likely impact on the ultimate user, the policyholder?

Mr. SAPNAR. The other issue as collectibles, we would be—if it is not adopted and we want to trade in the EU, we would move capital outside the United States. That capital would be available first to EU policyholders before U.S. policyholders. So that is a disadvantage to U.S. policyholders who would be second in line to access that capital.

Senator WARREN. So you are saying that you think if we abandon this, it means higher risk for U.S. policyholders.

Mr. SAPNAR. Higher risk——

Senator WARREN. Because there will be less capital for them to draw on if there is a problem.

Mr. SAPNAR. In the United States, that is correct.

Senator WARREN. All right. I know I am over. Can I have just a little bit longer?

Chairman CRAPO. A little.

Senator WARREN. Just a little bit. So the last two, you have got to be short. I am out of time. Mr. Henderson? And the Chair is being very indulgent.

Mr. HENDERSON. Great question. So reinsurers get less costs because no offices, they do not have to have the collateral there. I can tell you that pricing will not go down. It is an all-time low today, and their capital is an all-time high. This is a recipe for low pricing. It is not going to change. So that cost to me will not go down. That is a cost that is passed on to the policyholder.

The regulator in the U.S., I have just heard, which scares the heck out of me, that they are saying, well, if collateral is gone, then we are going to have to carry more capital, because now we cannot rely on their collateral to pay it; we have got to put up our own. If that is the case, costs will go up, direct to the consumer.

If it is abandoned—your next question, if it is abandoned, then reinsurers, the only thing that we will really get is reinsurers are going to have to open an office in the EU. He is going to pay more money for it. He is not going to be happy about it. But, again, prices an all-time low, capital is an all-time high, there is going to be no increase in reinsurance pricing. We will find out when I negotiate; I go to London tomorrow where more of this business is done. No one is talking higher prices.

Senator WARREN. OK. And, Mr. Zaring, if you could do this really quickly.

Mr. ZARING. I will just say very briefly that, look, this agreement increases competition in the reinsurance market, and I really hope and expect that it will be eventually and ultimately good for consumers.

And, second, there is nothing in this agreement that changes the traditional focus of State regulators on consumer protection. This does not touch it, and so I expect that consumer protection mission will continue unchanged.

Senator WARREN. OK. I very much appreciate it. Thank you, Mr. Chairman. You know, I think if we are thinking about signing on to an international agreement like this, this is the question we should dig down in. And I am a little disturbed about the fact that we do not have some good data based analogs that we can see how, when you make changes, it affects prices one way or the other.

Chairman CRAPO. I agree.

Senator WARREN. But thank you very much. I appreciate it, Mr. Chairman.

Chairman CRAPO. Thank you.

Senator Scott.

Senator SCOTT. Thank you, Mr. Chairman. And thank you for, A, holding this important hearing; B, having a unique panel with very varied opinions that are very clear and stark; and, C, having spent about 23 years in the insurance business, I am a fan of the State model. Without any question I think it is the best model we have seen, and it has been successful for a very long time for a couple of very important reasons.

At the same time, I know that as we engage in an international conversation about insurance regulations and norms, it is important for us to look for that equilibrium that we—obviously, I do not think we have found it today, as I listen to the hearing, but I do have a couple of questions about who is in the room and who is at the table. So being in the room is one question that you guys have done a pretty good job of answering. NAIC, in the room, without staff, without general counsel, without the experts that could help you understand and appreciate the direction of the agreement. I heard Senator Rounds talk about the—I will not say the words because I do not want to upset Senator Brown. I will not say we have to pass it in order to know what is in it and then create 30,000 pages of regulations to get that clarity. I will not say that. But I will suggest, however, that it feels like the certainty and the clarity is not there yet. The negotiations, as I was listening to it in my office, seems to suggest that the negotiations themselves will help us get that clarity because, after all, that is what you do after an agreement is signed. Well, I would hope that is what you do before the agreement is signed, just personally.

But the question I have, not about being in the room or being at the table, my question is, Ms. McPeak, do you have any confidence that the NAIC will be not a part of the conversation but at the table represented in a way that preserves what I believe is the best insurance model in the world?

Ms. MCPEAK. Well, I think it is important to say we do not know. Based on the plain language of this agreement, it is unclear who will be serving on that joint committee to resolve these very important issues. My colleagues and I are willing to implement the terms of this agreement to solve this problem, again, not of our making, but we just need to know the rules of the road. We need to know that the blueprint for our house that we are building will actually suffice under the terms of this agreement. If not, then there is going to be some kind of resolution through a joint committee that we may not even be able to participate in.

Senator SCOTT. A second question for you, and then we will work around the panel. It is my understanding that permanent equivalence was granted to companies based in the Bahamas and Switzerland but not in the U.S. Is that accurate, Ms. McPeak? And then everyone can chime in.

Ms. MCPEAK. That is accurate. Bermuda and Switzerland went through an equivalence process through Solvency II that was specified, and the United States has chosen not to participate in that determination. It was going to require changes to our financial regulatory system that we were not willing to undertake.

I think that it is a bit absurd that the two most sophisticated insurance markets in the world have to undergo some equivalence process, again, under the creation of the European Commission's direction in Solvency II.

Senator SCOTT. Anyone else want to weigh in? Mr. Sapnar.

Mr. SAPNAR. Well, what this agreement does is actually formally recognize the U.S. State regulatory system as a strong and robust system for the first time ever. There are no requirements for the States to change the regulation whatsoever. So I think that is a great outcome for that, and that will set the standard as other global negotiations go on on accounting standards and other capital standards. The recognition of the U.S. system is clear in this agreement, and that is very important.

Senator SCOTT. Mr. Henderson.

Mr. HENDERSON. Well, I guess if it was really clear, you would not have Julie Mix McPeak saying it is not. I think that sort of speaks for itself.

Mr. MCRAITH. I think, Senator, if—oh, I am sorry.

Senator SCOTT. Mr. McRaith.

Mr. MCRAITH. Just very clearly and briefly, as a State commissioner I testified in front of this Committee and others expressing our opposition undergoing an equivalence process. When we started the negotiations, our focus was: How will U.S. industry be treated? How will the U.S. system be recognized? So we did not want to use the term "equivalence." That is an EU term. Nobody quite knows entirely what it means. We in the agreement negotiated terms that are clear about how the U.S. system is recognized and respected and how the U.S. will supervise its companies as it deems appropriate.

Senator SCOTT. Mr. Zaring.

Mr. ZARING. In my view, the agreement does not require the Solvency II process to go ahead, but resolves most of the problems posed by imposing a Solvency II type regime on American insurers. So in that sense, it is better than a Solvency II equivalence demonstration.

I also just wanted to say that I have reviewed this agreement, and I look at these international regulatory cooperative agreements on occasion, and they can be very, very short and terse. This is longer than the first Basel Capital Accord, longer than the Memorandum of Understanding the SEC has with its foreign counterparts. I think there is a level of detail here that is appropriate, and when it comes to international regulatory cooperation, we do not necessarily want or expect something like a trade treaty or a 1,000-page bill or something like that. So I think that is important to remember.

Senator SCOTT. Thank you, Mr. Chairman.

Chairman CRAPO. Thank you.

Senator Tillis.

Senator TILLIS. Thank you, Mr. Chairman. Thank you all for being here.

Mr. Henderson and Ms. McPeak, you all have—well, actually, I think Mr. Henderson first, you were talking about how this would have an impact on premiums. I think Mr. Zaring said that hopefully this would result in a positive impact. So one thinks that there is some optimism in this agreement that will get us to a positive outcome. The other one who sits on top of an insurance company as the CEO says it is going to raise premiums. Can you help me reconcile that or give your basis for that?

Mr. HENDERSON. Well, no disrespect to Mr. Zaring, but he studies the stuff. I live it, and I know how the pricing works and all the pieces of it. We are a mutual company, so we do not have stockholders. It is pretty much we serve our policyholders. We try to keep the prices reasonable, not make too much money and all that stuff. And there is nothing I see in here that is going to cause us anything but higher costs, most particularly because of the capital which is going to be required because of no collateral.

Senator TILLIS. Mr. Sapnar.

Mr. SAPNAR. With due respect, I think I was the one who said there would be benefits, and I am a CEO of a reinsurance company. And I would say that when you have collateral, you tie it up. You cannot sell that same capacity again. So, by definition, you have limited capacity and, therefore, prices could go up. By releasing collateral, there is more ability to sell to the client.

Second, again, without this agreement, companies will be forced to move capital outside the U.S. You may not see the cost tomorrow, but when the failure comes or a financial crisis comes and that capital is not in the U.S., you will see the cost. And that is a big and dear cost to pay as opposed to incremental costs on a daily basis.

Senator TILLIS. Ms McPeak, can you tell me a little—well, actually, I have maybe a question that I want you and Mr. McRaith to respond to. Mr. McRaith, you said that the joint committee, the governance structure is something that needs to be worked out over time. I would think the stakeholders that are on the other side of the issue—I was in the legislature down in North Carolina for 8 years. Governance structures baked into the base of legislation tended to be the way to get the parties on board because they felt like they had a fair venue for working out differences or clarifying the ambiguities.

What would be wrong with consideration for that as a way to address some of the concerns that have been expressed here?

Mr. MCRAITH. I completely——

Senator TILLIS. Just time or——

Mr. MCRAITH. Look, I think you are absolutely right that the issue, though, of who attends and participates depends on the underlying issue itself. So, again, I think what the agreement shows and demonstrates is a commitment to include State regulators as appropriate in the U.S. system, again, completely unprecedented in American history. But, second, which commissioner would depend on the issue. It might involve an issue the North Carolina commissioner should participate in. Why would we want a commissioner from Oregon instead? So that kind of flexibility is necessary for the joint committee.

Senator TILLIS. Ms. McPeak, I want you to respond to that, but also talk a little bit about how this would affect Tennessee. By the way, I have got a brother in the State House there. He just started back in January. But if you were to take the agreement as it is proposed, what do you do? What goes on in Tennessee? How does it affect the consumer or the business in Tennessee?

Ms. MCPEAK. Well, that is the issue that I would like to reiterate today. You know, Mr. McRaith is talking about one insurance regulator on the joint committee. Why does it have to be one? Why couldn't it be a group of three? The problem is we just do not know. And I am saying, with all due respect to the rest of our panelists here, my colleagues and I are tasked with implementing this agreement. We are the only ones at the table that will have that responsibility. We do not know how to comply with some of the provisions that we have provided to this Committee in a list of issues that need clarification.

Further, we do not know that we have one or maybe even two or three seats on this joint committee to be named later. That is an issue for us because as we have recognized, there is a very real problem with disparate treatment of our companies in the European Union, and if we do something incorrect or not conceived as part of this agreement, we could void the entire agreement because of the cross-conditional issues in the agreement itself. And so we could be back right here today with these exact same issues just because we did not have clarification before we started building a process to implement these requirements under the agreement.

As for actions in Tennessee, we have already passed in Tennessee the Credit for Reinsurance Model Act adopted by the NAIC in 2011. So for me, we would begin working as insurance regulators across the Nation to come up with consumer protection requirements, put those into a model act to be adopted by the National Association of Insurance Commissioners and take those to our individual State legislatures and Governors for adoption, and keep in mind, when 39 of us have already been there asking for our own model for reinsurance collateral reduction in the last several years or so.

So, you know, we need to be very clear that whatever product we come forward with to implement this agreement is going to be sufficient under the consideration of the agreement itself.

Senator TILLIS. Thank you.

Thank you, Mr. Chair.

Chairman CRAPO. Thank you very much. That concludes the Senators who have sought to ask questions. I am going to ask one more question before we wrap up and then make a general request to all of the witnesses to respond in writing to another question.

As a matter of fact, Senators can submit questions to you after the hearing is concluded, and we encourage you to respond within 1 week of the receipt of those questions, and I will tell the Senators we expect those questions to be submitted within 2 days.

The question I have is just for Mr. McRaith and Ms. McPeak, and these can be very brief answers. I just want to try to see if I am understanding this accurately. In Article 4 of the agreement, group supervision by the host jurisdiction is not authorized at the worldwide parent level. However, Article 4(h) allows the host to apply a group capital assessment at the worldwide parent level if the home jurisdiction does not have a sufficient group capital assessment.

Now, Mr. McRaith, first, is it your belief that the States are adequately protected under this clause?

Mr. MCRAITH. Absolutely. Let me be clear. Article 4(h) says—clarifies. The States have been working on a group capital calculation for over 2 years now. What the agreement says is for those companies that operate in the EU and the U.S.—not Mr. Henderson's company, but those that are operating in those two jurisdictions, the States have an additional 5 years to develop their group capital calculation, and it does not prescribe the manner, the content, the specifications of that calculation, period.

Chairman CRAPO. All right. And, Ms. McPeak.

Ms. MCPEAK. I would completely disagree. The language that you read from Article 4 that talks about group supervision causes us concern that we may not be able to require and request the financial information that we are currently allowed to collect on European companies under State law today.

Further, we do not know whether our group capital assessment tool that we are working on will be sufficient under Article 4 to meet the terms of the agreement because we are looking at the assessment as one regulatory tool, and we have a lot of other regulatory authority to step in; if we saw an issue of capital that we could require many different courses of action other than adding additional capital to the company. We believe that the pure text of the agreement would indicate that we can have the capital assessment or there must be some capital assessment that goes on, but the solution for that is more capital, and we do not think that that is always the answer.

Again, it is an ambiguity that we just need clarification on before we begin the process.

Chairman CRAPO. All right, and thank you. I want to thank all the witnesses for bringing your expertise to us and helping us to understand this issue better.

The question that I would like to submit to you that I would like you to respond to in writing is really the first one that I asked. There is obviously some disagreement about whether there is sufficient clarity, and that raises the question of can we resolve this disagreement without reopening the agreement. Can these issues be resolved through some type of joint letters of understanding or clarification? Or will that undo or require reopening of the agreement? I would just like all five of the witnesses to just respond to us on that question if you would.

And, with that, again, I want to thank our witnesses. You have all been very helpful today. Recently, we have heard from many industry participants and stakeholders about a provision in Dodd–Frank regarding how the independent insurance expert to the Financial Stability Oversight Council will serve once his term expires. This is an important role on FSOC given the Council's authority to designate nonbanks. Mr. Woodall's term expires in September, and the statute is unclear on the holdover structure. I think there is an issue that Ranking Member Brown and I can work on in a bipartisan manner to provide additional clarity. I just wanted to announce that we intended to do so.

Senator BROWN. And we will certainly work with you. Thank you.

Chairman CRAPO. All right. Thank you very much.

With that, this hearing is adjourned. And, again, thank you very much to all of our witnesses.

Senator BROWN. Thank you all.

[Whereupon, at 11:20 a.m., the hearing was adjourned.]

[Prepared statements, responses to written questions, and additional material supplied for the record follow:]

PREPARED STATEMENT OF MICHAEL T. MCRAITH

FORMER DIRECTOR, FEDERAL INSURANCE OFFICE, DEPARTMENT OF THE TREASURY

MAY 2, 2017

Chairman Crapo, Ranking Member Brown, Members of the Committee, thank you for inviting me to testify in this hearing "Examining the U.S.–EU Covered Agreement".

I previously served as the Illinois Director of Insurance from 2005–2011, and as the Director of the Federal Insurance Office (FIO) at the U.S. Department of the Treasury from 2011 until January 20, 2017.

While serving as the FIO Director, among other things, I coordinated and developed Federal policy on prudential aspects of international insurance matters and served as Treasury's lead negotiator for the "Bilateral Agreement Between the European Union and the United States of America on Prudential Measures Regarding Insurance and Reinsurance" (Covered Agreement).

The Covered Agreement will open the entire European Union (EU) reinsurance market to U.S. reinsurers, spare U.S. industry potentially billions of dollars in compliance costs, and embrace the U.S. State regulatory approach to insurance group supervision.

I first testified before Congress on June 20, 2006, on behalf of the National Association of Insurance Commissioners (NAIC) in the U.S. Senate Committee on the Judiciary, and offered testimony in support of the limited anti-trust exemption in the McCarran–Ferguson Act. As in that first hearing, and in every hearing since, I reiterate today my support for the U.S. integrated system of insurance oversight wherein the States remain the primary regulators of the business of insurance.

Most States have diverse insurance markets in which multinational insurers of great size, scale and complexity compete against insurers that operate only in one State, or in only one region of one State. As the Director of Insurance in Illinois, I witnessed firsthand the importance of all aspects of the insurance industry to consumers, to local and State economies, to employees, and to our national interests. Insurance agents, brokers, and companies are an essential feature of every American community.

Insurance is a necessary component of America's promise of economic fairness and opportunity. Competitive insurance markets benefit America's working families and small businesses. Products and services offered by America's insurers allow families to protect and accumulate property, to transfer wealth between generations, and to support a financially secure retirement.

Indeed, FIO's Covered Agreement authority recognizes the global interests of the U.S. insurance sector and the implications of those interests for the American insurance industry and consumers. For these reasons, among others, Treasury and the United States Trade Representative (USTR) jointly negotiated and agreed upon the Covered Agreement with the EU.

On February 16, 2017, the U.S. House of Representatives Committee on Financial Services held a hearing entitled "Assessing the U.S.–EU Covered Agreement". Annex A to this written testimony contains replies to Questions for the Record that followed that hearing. In particular, the reply to the first QFR provides a paragraph-by-paragraph description of the legal benefits of the Covered Agreement for the United States.

To highlight a few key points:

1. "Equivalence", as defined by the EU, would require the United States to implement a global group capital requirement. The Covered Agreement will preserve the independence of the U.S. approach to insurance group supervision.
2. Reinsurance collateral reforms, drawn from the approach that State insurance regulators have adopted as a requirement for every State, do not have retroactive effect and cannot change existing reinsurance agreements.
3. The entire Covered Agreement is cross-conditional. Both the United States and the EU must provide the benefits in order to receive the benefits. Any unilateral action adverse to the other could result in the loss of the benefits of the Covered Agreement.

Background

The prudential insurance matters addressed by the Covered Agreement are neither new nor surprising. Reform of the U.S. State reinsurance laws was first debated by State regulators in 1999, if not earlier, well more than a decade before State regulators unanimously adopted modernized model laws and regulations in November 2011.

However, despite energetic efforts by State regulators through the NAIC, only 32 States have adopted some version of reinsurance reforms. Both the content and the implementation of that reform varies across those 32 States. For this reason, among others, State regulators, through the NAIC, opted in 2016 to establish reinsurance reforms as an NAIC accreditation standard, effective January 1, 2019. By virtue of this NAIC decision, all States must adopt a law or regulation substantially similar to the NAIC model law and regulation by January 1, 2019.

While the NAIC spent years working through alternative approaches to reforms of State-based credit for reinsurance laws, the EU spent years developing its Solvency II insurance supervisory regime. Solvency II was first previewed and anticipated more than 10 years before its implementation on January 1, 2016. The EU and its member States should be congratulated on the successful technical development and implementation of Solvency II, an EU-wide system of insurance oversight that reflects a high level of professional and political accomplishment.

Almost from the earliest days of the development of Solvency II, U.S. insurance sector stakeholders, including State regulators, were aware that Solvency II could require the EU to evaluate whether non-EU insurers and reinsurers operating in the EU market were domiciled in "equivalent" jurisdictions. An "equivalent" jurisdiction is one, such as Switzerland, which supervises its insurers consistent with Solvency II practices and standards, i.e., global group capital, reporting and governance.

Among other reasons, Solvency II and its supervisory approach matter to the United States because, in terms of premium volume, the EU's consolidated insurance market is the largest in the world. Also, EU insurers and reinsurers operating in the United States provide insurance and annuity products to millions of American families and businesses, employ tens of thousands of Americans in States around our country, and provide essential capital following a disaster, including 9/11, Hurricanes Katrina, Rita, and Wilma, and Superstorm Sandy.

As the world's largest single Nation insurance market, U.S. insurance authorities have repeatedly refused submission to the formal EU Solvency II equivalence process. The United States has long-held that the United States substantively and structurally regulates its insurance sector as the United States determines appropriate, just as the EU determines how to supervise the insurance sector within the EU. The Covered Agreement affirms this independence.

Nevertheless, U.S. insurance stakeholders have known that failure to resolve the Solvency II "equivalence" issue could result in: (1) U.S. reinsurers losing opportunities in the EU reinsurance market, and (2) U.S. primary insurers being forced to satisfy Solvency II global group capita l, reporting and governance criteria that are far different, and far more costly, than current U.S. regulatory practices.

As the EU moved to implement Solvency II on January 1, 2016, U.S. insurance stakeholders learned more about the potential negative impact on U.S. reinsurers and insurers. At the same time, U.S. State insurance regulators continued the massive (albeit piecemeal) effort to reform reinsurance oversight. Nevertheless, in exchange for this reform, State regulators received nothing of benefit for U.S.-based insurers and reinsurers operating in the EU. Nothing.

Following often difficult and contentious negotiations that began in early 2016, the Covered Agreement will resolve these long-standing issues. The Covered Agreement will remove excessive unnecessary regulation of the global reinsurance industry in both markets, open the EU reinsurance market to U.S. reinsurers, and relieve U.S. primary insurers of potentially billions of dollars in Solvency II compliance costs.

While providing an equally meaningful outcome for the EU, the Covered Agreement puts America's interests first. U.S. insurance consumers, industry and the U.S. national economy will benefit from the Covered Agreement.

Covered Agreement Negotiations—Process and Transparency

U.S. State regulators, most of whom are appointed and serve at the will of a State Governor, have never before been directly included in the negotiating delegation for a U.S. international agreement. However, in recognition of the unique role of the States in insurance sector oversight, and even though not required by law, the Covered Agreement negotiation process created an unprecedented mechanism for State regulator participation.

Treasury and USTR asked the State regulators to establish a small covered agreement task force of commissioners, and allowed the State regulators to determine the size and membership of the task force.

State regulators were invited to, and did, participate in every Covered Agreement negotiating session.

State regulators were invited to, and did, share perspectives, technical insights, and ask questions during U.S. delegation preparations in advance of any Covered Agreement negotiating session.

State regulators were consulted throughout the Covered Agreement negotiation process, including during any Covered Agreement negotiating session.

During the Covered Agreement negotiations, a State regulator sat at the table with the U.S. delegation and frequently provided technical insights.

Through a confidential web portal established solely for purposes of sharing confidential Covered Agreement documents with the State regulator task force, State regulators received all documents offered by the EU shortly after those documents were received by Treasury and USTR.

Through the same confidential web portal, State regulator s received all U.S. Covered Agreement documents before those documents were provided to the EU.

Before any U.S. Covered Agreement document was provided to the EU, State regulators were invited to, and did, participate in a telephone call with Treasury and USTR to provide State regulator feedback and insight, and to ask questions. These telephone calls frequently resulted in important insights and perspectives that were incorporated into, or addressed in, the U.S. Covered Agreement document before that document was provided to the EU.

Prior to my departure from Treasury, both Treasury and USTR expressed appreciation to Tennessee Commissioner McPeak and her colleagues from California, Texas, Missouri, Florida, Vermont, Wisconsin, Kentucky, Maine, and Montana for their constructive input and insights provided throughout the Covered Agreement negotiation.

U.S. State regulators made important contributions that improved the outcome of the Covered Agreement. These regulators, including Commissioner McPeak, should be commended for contributing substantial time and energy to the Covered Agreement negotiations even while tending to the business of insurance in their home States and to the various NAIC activities in which they are engaged.

In addition, throughout the Covered Agreement negotiations, Treasury and USTR consulted extensively with the four Committees of jurisdiction in Congress. These consultations occurred in person and by telephone, and occurred before negotiations began, before and after each negotiating session, and before the negotiations and the Covered Agreement were finalized.

Treasury and USTR also extensively consulted with private sector stakeholders, particularly those U.S. insurers and reinsurers with operations in the EU.

Treasury and USTR also worked closely with the entire U.S. Covered Agreement negotiating delegation which, in addition to Treasury and USTR and the State insurance regulators, also included the Departments of Commerce and State, and the Board of Governors of the Federal Reserve System.

This extensive transparency and stakeholder engagement supported and informed Treasury and USTR's work throughout the Covered Agreement negotiating process.

Credit for Reinsurance Reform—Removing Excessive Regulation of a Global Industry

The reinsurance industry largely manages risk on a global basis. The reason is obvious: in order to avoid concentration of risk from natural catastrophes, or from a mass epidemic, reinsurers spread capital to different areas and continents. Insurance supervisors support this approach in order to promote affordable and reliable reinsurance markets and, in turn, promote the affordability and accessibility of insurance products to working families and small businesses throughout the United States.

The Covered Agreement supports the U.S. State-based initiative to reform reinsurance regulation. In fact, the 32 U.S. States that have already adopted reinsurance collateral reform have, as of early 2017, provided collateral relief to 31 non-U.S. reinsurance entities. Of those 31, 30 now hold 10 percent or 20 percent of the collateral required under prior State laws.

The State regulators' adoption of reinsurance collateral reform as an accreditation standard, effective January 1, 2019, means that all States would be expected to adopt a substantially similar reform by that date. In other words, within the next 2 years, as a matter of State law, every non-U.S. reinsurer could be posting as little as 10 percent–20 percent of the collateral formerly required by the States.

If domiciled in a non-equivalent country, a reinsurer operating in the EU could be subject to EU member State laws that require collateral, a local presence, or other prohibitive regulatory requirements. Beginning in mid-2016, U.S. reinsurers were losing existing EU clients and missing new opportunities in the EU. Before the Covered Agreement was provided to Congress on January 13, 2017, U.S. reinsurers were experiencing this burden in full force: at least two EU member States, with more in process, required that U.S. reinsurers either establish a subsidiary or operate in the EU member State only without the use of brokers.

The Covered Agreement eliminates collateral and local presence requirements for EU reinsurers operating in the United States and U.S. reinsurers operating in the EU. The Covered Agreement eliminates excessive reinsurance regulation in the United States and the EU, and establishes a new global paradigm for oversight of this essential global industry.

If the Covered Agreement conditions are met, current collateral requirements for EU-based reinsurers will be eliminated within 60 months from the date the Covered Agreement enters into force or, perhaps, as early as mid-2023. States, therefore, have sufficient time beyond the NAIC' s existing plan for accreditation (January 1, 2019) to conform all State law and regulation to the terms of the Covered Agreement.

In addition, if the Covered Agreement conditions are met, current local presence requirements for U.S. reinsurers in the EU (or EU reinsurers in the United States) will be eliminated within 2 years from the date of signature. Due to the success of the Covered Agreement negotiations, EU member States that were imposing local presence requirements on U.S. reinsurers are already forbearing from enforcement of local presence requirements.

By combining meaningful reporting requirements with the potential for re-imposition of local presence or collateral requirements, the Covered Agreement enhances the protections available to primary insurers and consumers in both the EU and the United States. For example, a reinsurer must confirm in writing that it consents to the jurisdiction of the courts where the primary insurer is domiciled, and must consent in writing to pay all final and enforceable judgments wherever enforcement of that judgment is sought. Also, reinsurers must maintain a practice of prompt payment, and could be required to report to the ceding insurer' s supervisor semi-annually with an updated list of all disputed and overdue reinsurance claims that have been outstanding for 90 days or more.

These protections, and the myriad others contained in the Covered Agreement, apply to U.S. reinsurers operating in the EU and to EU reinsurers operating in the United States.

In exchange for these enhanced consumer protections, the EU and U.S. reinsurance markets will be open to nondomestic competition in an unprecedented manner, thereby providing free market opportunities that will meaningfully benefit ceding insurers and insurance consumers.

Finally, and importantly, the Covered Agreement provides that U.S. State law and regulation (and EU law and regulation) can revert to its prior form if the Covered Agreement is terminated. Termination of the Covered Agreement will allow for the "snap back" of collateral or local presence requirements, precluding the prospect that the EU or United States could benefit from the Covered Agreement despite failing to provide the benefits.

Group Supervision—Mutual Respect Finalized

In Article 4, the Covered Agreement describes insurance group supervision practices in a manner that accommodates the distinctly different approaches of both the United States and the EU. Annex A includes a description of the legal benefits of each paragraph of the Covered Agreement, including Article 4.

Notably, the group supervision practices of the Covered Agreement (Article 4) apply only to those insurers operating in both the EU and the United States.

For purposes of defining the scope of the group, the Covered Agreement retains flexibility for the United States and the EU to move forward as each deems appropriate. The scope of the group is understood to be consistent with Insurance Core Principle (ICP) 23 developed by the International Association of Insurance Supervisors and in effect in early 2017.

Through the Covered Agreement, the EU and the United States agree that supervisors of the jurisdiction in which the insurer (or reinsurer) is domiciled are the only supervisors with authority to supervise the insurers at the global group level.

The Covered Agreement group supervision practices memorialize the mutual respect shared by the EU and the United States, and comprise explicit recognition that neither the EU nor the United States will change insurance regulatory systems and structures just because of the other. As a factual matter, supervisors in both jurisdictions have adopted, or pursued, practices that originated with the other. For example, U.S. State regulators began development of an Own Risk Solvency Assessment (ORSA) based on the idea as it originated with the EU. Over time, U.S. State regulators adopted the ORSA but in a U.S.-specific way. At the same time, EU supervisors have studied the U.S. State regulators' approach to the collection, compilation and publication of insurance industry data, and are developing a system of insurer reporting that, while different from the U.S. State approach, is based on ideas as originated in the United States.

Beginning in 2014, U.S. State insurance regulators, through the NAIC, began development of a group capital calculation for U.S. insurers and reinsurers. This initiative reflects a growing awareness among international insurance supervisors that a common group capital standard for multinational insurers will allow for non-domestic insurance regulators to protect consumers and promote financial stability within their jurisdictions. Although the NAIC group capital initiative has been under development for over two years, it remains in the early phases as State regulators evaluate alternative approaches both to the scope and the technique for the calculation.

It is clear, however, that the NAIC's group capital calculation will not be a group capital requirement, and will not require capital to be held by U.S.-based insurers and reinsurers in any place other than the insurance legal entities over which State regulators have authority. The Covered Agreement confirms these two facts, and provides U.S. State regulators with flexibility to build the U.S. group capital calculation on specifications that they determine appropriate. To repeat for clarity, the Covered Agreement only requires that U.S. State regulators proceed with group capital work already underway through the NAIC and does not specify how that work should proceed or conclude.

To be abundantly clear, the Covered Agreement will not require that U.S. State regulators develop an approach that requires capital to be held outside of an insurance legal entity, and the reference to "corrective, preventive, or otherwise responsive measures" merely restates existing State-based insurance holding company laws. Indeed, to repeat again for clarity, the Covered Agreement further limits the application of the State regulators' group capital calculation to a much smaller group of U.S. insurers and reinsurers (i.e., only those operating in the EU) than presently contemplated by the State regulators.

Importantly, just as the United States sought respect for the U.S. approach to its group capital calculation, the Covered Agreement is also drafted in a manner that accommodates and expresses respect for the EU approach to a global group capital requirement. Although different from the U.S. approach, Solvency II has formed the basis for insurance regulatory reforms around the world, including in Mexico, South Africa, Bermuda, Brazil, and China.

The Covered Agreement limits the application of the EU's Solvency II global group supervision practices to the operations and activities of U.S. insurers that occur in or originate from the EU. While the same limitation of U.S. law and regulation also applies to EU insurers operating in the U.S. market, the limitation on the application of Solvency II saves U.S. insurers potentially billions of dollars in additional compliance costs.

The Covered Agreement will benefit U.S. insurance consumers through increased affordability, increased insurer investment in the U.S., and more efficient use of the capital that would otherwise be tied to Solvency II compliance. The Covered Agreement provides U.S. insurers operating in the EU with the strategic flexibility necessary for continued domestic and global growth.

The Covered Agreement will provide insurers and reinsurers that operate in both the United States and the EU the long-sought clarity and certainty with respect to the relationship between the two different supervisory approaches. The Covered Agreement incorporates, and memorializes, shared mutual respect between the EU and the United States.

The Covered Agreement Resolves Reinsurance and Group Supervision With Finality

Neither the United States nor the EU can benefit from the terms of the Covered Agreement without also providing to the other the benefits of the Covered Agreement. In other words, the provisions of the Covered Agreement are cross-conditional.

If the United States fails to perform on the reinsurance reforms, then the EU need not comply with the group supervision practices. If the EU does not comply with the group supervision practices, then the United States need not comply with the reinsurance reforms. The cross-conditional nature of the Covered Agreement incentivizes compliance by supervisors in both the EU and the United States.

The Covered Agreement need not be clarified with further written materials. The Covered Agreement terms, painstakingly negotiated, are abundantly clear even if not written to resolve every stakeholder's nuanced fantasies.

For example, if a stakeholder were to complain about the uncertainty of 5 years hence, one might ask that stakeholder to explain whether that same question can be raised about every agreement or, for that matter, every facet of life, or, in fact, any subsequent written material that stakeholder may claim to be essential. For this reason, the cross-conditional nature of the Covered Agreement allows for the United States to provide the benefits of the Covered Agreement only insofar as the EU also provides the benefits. Both sides are disciplined into compliance with the Covered Agreement.

To the extent that the EU and the United States have questions about interpretation or implementation in the coming years, the Covered Agreement establishes a Joint Committee to address and resolve any ambiguity. This Joint Committee mechanism, not unlike those established to implement other international agreements, would allow for both broad and targeted subjects to be addressed in a collaborative manner.

Finally, if both the EU and the United States have complied with the Covered Agreement conditions, then the terms of the Covered Agreement become permanent and final. See Article 10, paragraph 1.

Federal Insurance Office

After the devastation wrought by the financial crisis, Title V of the Dodd–Frank Consumer Protection and Wall Street Reform Act established FIO to complement the work of the States with respect to the U.S. insurance regulatory system. Among other authorities, FIO has statutory authority to represent the United States on prudential aspects of international matters. In doing so, FIO has worked closely with the insurance professionals at the Board of Governors of the Federal Reserve System, State regulators, and staff at the NAIC. In addition, working with our international counterparts, FIO supported international consensus that accommodates the substance and structure of the U.S. insurance regulatory system.

Make no mistake—U.S. leadership in the global insurance sector is more important now than ever before. Developing economies around the world seek private capital and insurance products to provide the same benefits to their populations that the industry provides to families and businesses in the United States.

Where the United States does not engage, or lead, then the United States cedes the development of regulatory concepts to other jurisdictions. The global insurance community will not wait for the United States if we repeatedly re-hash the currently unchallenged merits of the McCarran–Ferguson Act.

The U.S. insurance industry, in all of its diversity, deserves prominent U.S. Federal leadership on important global insurance matters. For those who would argue that only a State (which State?) should have this role, the actual salient question is whether the United States prefers to lead or to follow.

As an industry of $8.5 trillion in assets (2015 total) in the United States, and a critical tool for all aspects of American personal and commercial activity, the U.S. insurance sector deserves a heightened prominence in the U.S. Department of the Treasury. Recent proposals, including by the Bipartisan Policy Council, affirm the increasing awareness of the U.S. insurance sector's national and global importance.

Industry and consumers have a shared interest in efficient, well-regulated and competitive markets. FIO has published 16 reports, including on topics relating to insurance consumer matters and the development of an affordability index of personal auto insurance. This work highlights the State-by-State differences and the impact of those differences on the insurance industry and the American people.

FIO has engaged domestically in, or led U.S. engagement in, a broad range of matters, including retirement security, resilience to severe weather events, cybersecurity, implementation and interpretation of the 2015 terrorism risk insurance program, as well as nuts and bolts insurance projects such as flood insurance and long-term care insurance. This engagement has assured that insurance matters of national interest and concern are identified, recognized, understood, and appreciated at the highest levels of the Federal Government.

As one of the most highly regulated and quickly evolving financial services, the U.S. insurance sector—consumers and industry—deserves strong national and global representation and leadership. Federal leadership, including through Congress, will be increasingly necessary to address important insurance issues of national interest.

Conclusion

Treasury and USTR pursued a Covered Agreement that would memorialize the obvious prerogative of the United States to determine the substance and structure of U.S. insurance oversight. In addition, Treasury and USTR sought a Covered Agreement that would provide meaningful benefits for U.S. insurers, reinsurers, consumers, and for the U.S. economy. While providing equally meaningful benefits for the EU, this Covered Agreement achieves all objectives sought by the United States.

At every point in the Covered Agreement negotiation, Treasury and USTR prioritized the best interests of U.S. consumers, U.S. insurers and the U.S. economy.

Chairman Crapo, Ranking Member Brown, thank you for the opportunity to speak with you today. I look forward to your questions.

ANNEX A

McRaith Replies to Questions for the Record

U.S. House Financial Services Committee

Subcommittee on Housing and Insurance

"Assessing the U.S. – EU Covered Agreement"

February 16, 2017

U.S. House of Representatives Financial Services Committee
Hearing: "Assessing the U.S. – EU Covered Agreement"
February 16, 2017
Michael T. McRaith
Replies to Questions for the Record

Chairman Duffy

Question Number One

The Covered Agreement (Agreement) opened the entire EU reinsurance market to U.S. reinsurers, spared U.S. industry operating in the EU potentially billions of dollars in compliance costs, and embraced the U.S. state regulatory approach to insurance group supervision.

The Agreement applies only to, and provides clarity for, U.S. and EU insurers that operate in both jurisdictions. Notably, the benefits are not mutually exclusive in that a positive outcome for EU industry stakeholders can also benefit U.S. interests.

EU insurers and reinsurers insure millions of American families and businesses and employ tens of thousands of Americans in states around our country. EU-based holding companies own high profile U.S. property and life insurers. EU-headquartered insurers and reinsurers pay billions to assist the United States in post-disaster recovery. For example:

- EU insurers and reinsurers paid more than $12.2 billion in claims following the terrorist attacks of September 11, 2001, an event for which 64% of all claims were paid by reinsurers. Lloyd's paid more than 11% of all 9/11 claims.
- Following the devastation of Hurricanes Katrina, Rita and Wilma, more than 22% of all claims were paid by EU insurers and reinsurers, with Lloyd's paying nearly 10% of the total.
- Of the total insured claims of $18.715 billion from Superstorm Sandy, $5.3 billion was paid by EU-headquartered insurers and reinsurers, and approximately $2.5 billion was paid by Lloyd's.

This reply identifies only the legal benefits conferred upon the United States and its stakeholders (consumers and industry), and does not describe the financial and commercial benefits for those stakeholders.

The Agreement is drafted in language, and provides benefits, that apply equally to the United States and the EU. The following list of legal benefits conferred on the United States by the Agreement cites directly to the relevant Article and Paragraph:

a. Preamble: the Preamble reflects the understandings and acknowledgements of the United States and the EU with respect to the Agreement. While each is an important statement, three warrant specific mention:

"Sharing the goal of protecting insurance and reinsurance policyholders and other consumers, while respecting each Party's system for insurance and reinsurance supervision and regulation";

"Taking into account information exchanged on each Party's regulatory frameworks and after careful consideration of these frameworks";

"Acknowledging the need for a group capital requirement or assessment for insurers and reinsurers forming part of a group that operates in the territory of both Parties, and that a group capital requirement or assessment at the level of the worldwide parent undertaking can be based on the approach of the Home Party[.]"

b. Article 1 – Objectives

While Article 1 does not, in itself, confer any legal benefits for U.S. stakeholders, the Objectives articulate the goals of the Agreement. While each is important and are addressed in the following substantive Articles, these goals describe the outcome of the Agreement:

(a) Elimination of local presence requirements for U.S. and EU reinsurers operating in the other jurisdiction.

(b) Elimination of collateral requirements for U.S. and EU reinsurers operating in the other jurisdiction.

(c) Prohibit the application of group supervision by an EU regulatory authority except to the extent that the U.S. insurer has operations or activities occurring in or originating from the EU, including with respect to solvency and capital, governance and reporting.

c. Article 2 — Definitions

d. Article 3 — Reinsurance

Article 3 describes the Parties' affirmative commitments with respect to reinsurance.

Paragraph:

1. and 2. U.S. reinsurers will not be subject to collateral requirements, or any requirement of similar impact, when operating in the EU unless EU reinsurers are also subject to those requirements in the EU. This prohibition applies both to contractual arrangements and to regulatory credit to a ceding insurer for the purchased reinsurance.

3. U.S. reinsurers will not be subject to local presence requirements (i.e. the establishment of a subsidiary, holding company, or other legal entity) or any requirement of similar impact, when operating in the EU.

4(a) - (l). Relief from local presence and collateral obligations for an EU reinsurer in the United States is dependent upon the EU reinsurer meeting financial condition and market conduct standards. The details of these standards, which remove excessive regulation, track existing state-based law and regulation.

5. In addition to the information required by paragraphs 4(a) - (l), reinsurers may voluntarily provide information to regulatory authorities.

6. In the event that an EU reinsurer fails to meet the standards and requirements of paragraph 4, then U.S. insurance authorities may re-impose collateral requirements on that EU reinsurer.

7. Subject to applicable law, U.S. ceding insurers can negotiate any provision in any reinsurance agreement, including for collateral.

8. Existing U.S. reinsurance agreements are not affected by the Agreement, i.e. the Agreement does not have a retroactive effect. Consistent with basic contract law, reinsurance agreements cannot be unilaterally amended. An amendment to a reinsurance agreement can be limited to the targeted subject matter of the amendment without changing the remaining provisions of the agreement.

If, for example, a reinsurer changed its name, then the parties to that reinsurance agreement could agree to amend the existing reinsurance agreement with respect to the name change only, which would not alter the agreement's requirement for collateral.

These provisions are drawn from NAIC Model Regulation 786 (Credit for Reinsurance).

9. If the Agreement were terminated, then the United States and the

EU can again require the posting of collateral or the establishment of a local presence for a reinsurer domiciled in the other jurisdiction.

e. Article 4 — Group Supervision

This Article describes the mutual affirmation of group supervision practices of the United States and the EU, and describes group supervision practices to be adopted by both the United States and the EU upon the date of provisional application, (i.e. date of signature, as provided in Article 10, Para. 2(a)).

Article 4 applies only to those U.S. insurers operating in both the United States and the EU.

Article 4 acknowledges that the United States and the EU have different approaches and systems with respect to insurance group supervision, and provides clarity regarding the interaction of those approaches and systems going forward.

Paragraph:

(a) Recognizing the value of supervisory colleges, the Agreement clarifies that only U.S. insurance supervisors will supervise U.S. insurers at the worldwide group level. In other words, EU supervisors can apply EU law and regulation to U.S. insurers only for operations and activities that occur in or originate from the EU. This limitation applies to all aspects of group supervision, including solvency and capital, governance, and reporting.

In other words, U.S. insurers are supervised at the worldwide group level as determined by U.S. state insurance regulators.

(b) Subject to Article 3, U.S. insurers and reinsurers operating in the EU are subject to EU law and regulation only for purposes of operations and activities occurring in or originating from the EU.

(c) U.S. insurers are required to prepare only a U.S. state-based Own Risk Solvency Assessment (ORSA) at the worldwide group level, not both a U.S. and an EU ORSA. The summary report of the U.S. ORSA can be shared with EU supervisors through the insurer's supervisory college. In other words, at the worldwide group level, U.S. insurers will complete an ORSA consistent with U.S. state regulatory practices.

(d) The required elements of the ORSA, as described in this paragraph, are drawn from the NAIC Risk Management and Own Risk and

Solvency Model Act (#505) and the NAIC ORSA Guidance Manual.

(e) If the ORSA of an EU insurer or reinsurers reveals a serious threat to U.S. policyholders, then the U.S. insurance regulator may consult with the insurer's lead EU supervisor and may impose preventive, corrective or responsive measures.

(f) U.S. insurers operating in the EU report at the worldwide group level only to the lead U.S. insurance supervisor unless the information to be reported reveals a direct threat to activities or operations occurring in or originating from the EU. In other words, at the worldwide group level, U.S. insurers report consistent with U.S. state regulatory practices.

(g) U.S. regulators retain the ability to ask for information about non-U.S. activities that may pose a serious threat to the ability of an EU insurer or reinsurer to pay its claims in the United States.

This language tracks the "windows" of the NAIC Model Holding Company Act (#440) provisions that allow state insurance regulators to "scrutinize group activity and assess its potential impact on the ability of the insurer to pay its claims."

(h) As with all of Article 4, the group capital calculation applies only to U.S. insurers that operate in the EU. U.S. insurers and reinsurers operating in the EU are relieved of the EU's Solvency II group capital requirement upon the date of provisional application, i.e. the date of signature (Article 10, Para. 2(b)).

U.S. state insurance regulators who, in reply to international developments, have been developing a group capital calculation since 2014, have five years from the date of signature (Article 10, Para. 2(a) and 2(e)) to develop the group capital calculation for the subset of U.S. insurers operating in the EU. For that five (+) year period, and upon completion, U.S. insurers operating in the EU are not thereafter subject to reporting or maintaining the Solvency II worldwide group capital requirement. The language is not prescriptive in terms of the mechanics or specifics of the group capital calculation, but defers to the ongoing work of U.S. state insurance regulators.

The language regarding "authority to impose preventive, corrective, or otherwise responsive measures on the basis of the assessment, including requiring, where appropriate, capital measures" is intentionally broad. This language accommodates both the U.S. state regulatory approach (i.e. at the entity level) and the EU Solvency II approach (i.e. at the holding company level).

(i) If the EU exercises enhanced group supervision over a U.S. insurer for purposes of financial stability, then the United States can terminate the Agreement.

f. Articles 5 and 6 — Exchange of Information and Annex

These Articles encourage continued and enhanced exchange of confidential information across borders and encourage U.S. and EU supervisors to utilize the template attached as an Annex to the Agreement.

g. Article 7 — Joint Committee

Article 7 provides for the establishment of a Joint Committee to address questions of the Agreement's interpretation and implementation.

h. Article 8 — Entry into force

The Agreement enters into force seven days after the Parties exchange written notice that internal approval processes have been completed. However, timing for the effective date of the Agreement provisions is specified in Article 10.

i. Article 9 — Implementation of the Agreement

Article 9 describes that the EU and the United States shall take all measures to implement and provisionally apply the Agreement.

j. Article 10 — Application of the Agreement

The Agreement is entirely cross-conditional. Neither the EU nor the United States receive the benefits of the Agreement without providing the benefits of the Agreement. For example, if, five years from the date of signature, the EU were to reject the U.S. state regulatory approach to worldwide group capital for U.S. insurers operating in the EU, then the EU would relinquish the benefits of the Agreement for EU consumers and industry.

1. The Agreement applies to U.S. insurers operating in the EU on the date of entry into force, or the date of signature, whichever is later.

2. (a) U.S. insurers and reinsurers operating in the EU are relieved of Solvency II worldwide group requirements upon signature of theAgreement (i.e. the date of provisional application).

(b) Provided that the U.S. state insurance regulators comply with Articles 3 and 4, then the provisions and benefits of Article 3 and 4 will be received by U.S. consumers, insurers, and reinsurers.

(c) The exercise by the EU of enhanced supervision over a U.S. insurer or reinsurer for EU financial stability purposes (and vice versa) can be grounds for termination of the Agreement.

(d) U.S. state insurance regulators adopted the NAIC's reinsurance collateral reform as a national accreditation standard effective January 1, 2019 (i.e. every state would have a conforming law or regulation by that date). The Agreement provides the states with additional time, potentially into 2023, to adopt measures consistent with the Agreement.

(e) The EU will not impose a Solvency II worldwide group capital requirement on U.S. insurers and reinsurers operating in the EU for five years from the date of signature, and then only if the United States has not developed a group capital calculation as described in Article 4(h).

(f) If the EU does not meet the obligations of Article 3 with respect to the elimination of local presence requirements, then U.S. state insurance regulators may impose a worldwide group capital requirement or assessment on EU insurers and reinsurers. The inverse is also true.

(g) The EU will eliminate local presence laws within two years from the date of signature.

(h) U.S. reinsurers operating in the EU will not be subject to collateral requirements, or the equivalent, within five years from the date of signature.

(i) The Agreement provisions regarding the Joint Committee, Termination and Mandatory Consultation, and Amendment will be effective upon the date of signature.

n. Article 11 — Termination and Mandatory Consultation

Subject to the procedures established in the Agreement, the Agreement can be terminated at any time by either party.

o. Article 12 — Amendment

Article 12 sets forth the process for amending the Agreement.

Question Number Two

The Agreement opened the entire EU reinsurance market to U.S. reinsurers, spared U.S. industry operating in the EU potentially billions of dollars in compliance costs, and embraced the U.S. state regulatory approach to insurance group supervision, thereby conferring on U.S. consumers and industry the wide range of legal benefits described in reply to Question Number One.

Stakeholders were consulted extensively before and throughout the negotiation of the Agreement. For purposes of the Agreement negotiations, Treasury and USTR created and successfully utilized an unprecedented mechanism to include U.S. state insurance regulators the negotiation of an international agreement. For example, a total of ten regulators from nine states participated as members of the U.S. state insurance regulator task force that contributed significantly throughout negotiations of the Agreement, three of whom also served on FACI.

The Federal Advisory Committee on Insurance (FACI) was first created in 2011. FACI's existence and endeavors are guided by the Federal Advisory Committee Act (Pub.L. 92-463, 86 Stat. 77 (1972)). Given that Treasury and USTR engaged extensively with Congress, state regulators, and other stakeholders throughout the Agreement negotiations, and given that the Agreement provides material legal, financial and commercial benefit to U.S. consumers and industry, alteration of the FACI role would be both duplicative and unnecessary.

Question Number Seven

Congressional authority is not constrained by Title V of the Dodd-Frank Act. Further, the EU is a union of independent sovereign nations whereas every other counter-party would likely be a single nation. However, the Agreement involves prudential insurance and reinsurance measures, and is not a trade agreement. Without comment on matters of international trade, matters of prudential oversight such as those contained in the Agreement are qualitatively different. For example, Congress does not "expedite rejection" or approval of NAIC model laws and regulations.

As provided in Title V of the Dodd-Frank Act, frequent engagement with all four Congressional committees of jurisdiction was extremely meaningful and helpful throughout the negotiation of the Agreement.

Question Number Eight

Insurance markets are increasingly global, and multi-national U.S. insurers have tremendous opportunities for organic growth in the developing markets of Central and South America, Asia and Africa, and Eastern Europe. The Covered Agreement authority in Title V (the "FIO Act") of the Dodd-Frank Act may be necessary to address and resolve differences in the regulation of the business of insurance between the United States and other jurisdictions.

For example, when the FIO Act became law in 2010, few in the United States *or* the EU knew whether and, if so, when or in what form, the EU's Solvency II regime would be implemented. The Agreement illustrates that the Covered Agreement authority can resolve important issues of cross-border insurance regulation and, at the same time, provide potentially billions of dollars in value to the U.S. consumers and industry. Due to the variability of potential fact patterns in increasingly globalized insurance markets, the FIO's Covered Agreement authority has an appreciably growing value to American interests, and potential expansion of the authority may be necessary.

Question Number Nine

No. A Covered Agreement can be negotiated with one or more foreign jurisdictions.

The International Association of Insurance Supervisors (IAIS) is not a foreign jurisdiction but is a voluntary association of members formed under the laws of the Switzerland. In this sense, the IAIS is akin to the NAIC which, of course, is also a voluntary association of members formed under the laws of the United States but is not a "jurisdiction."

Further, as detailed in reply to Question Number One, the Agreement demonstrates that Covered Agreement will be used to preserve and enhance the U.S. system of insurance regulation.

Congressman Hultgren

A. Yes. Reinsurance agreements are subject to the principles of basic contract law. Amendments to contracts, regardless of the magnitude of the amendment, require an agreement of the parties to the contract. An amendment to a reinsurance agreement that could result in the reduction of collateral would require that both parties to that reinsurance agreement agree upon the amendment. Collateral could not be reduced if the ceding insurer did not also agree.

B. The Agreement does not have retroactive application. The hypothetical of a reinsurer's scheme of arrangement (a "Part VII transfer of business"), or the application of a jurisdiction's unique legal or regulatory system, depends upon numerous complex variables and cannot be answered in the abstract. However, Article 3 of the Agreement preserves the authority of a ceding insurer's U.S. state insurance regulator to re-impose collateral and other requirements on a reinsurer that fails to satisfy the Agreement's financial condition and market conduct standards. Further, a Part VII transfer would likely trigger the standard provisions of a reinsurance agreement that allow the ceding insurer to accelerate the posting of collateral

PREPARED STATEMENT OF JULIE MIX MCPEAK

COMMISSIONER, TENNESSEE DEPARTMENT OF COMMERCE AND INSURANCE, ON BEHALF OF THE NATIONAL ASSOCIATION OF INSURANCE COMMISSIONERS

MAY 2, 2017

Thank you Chairman Crapo, Ranking Member Brown, and Members of the Committee. My name is Julie Mix McPeak. I serve as the commissioner for Commerce and Insurance for the State of Tennessee and current President-Elect of the National Association of Insurance Commissioners (NAIC). I greatly appreciate your invitation to testify before you regarding the covered agreement between the European Union and the United States.

The NAIC is well aware of the disparate regulatory treatment some European Union (EU) jurisdictions are imposing on certain U.S. insurers doing business in the EU and are committed to working with Congress and the Administration to address this important issue for our sector. While a covered agreement is one way to do so, we have serious concerns with the text of the current agreement. It is ambiguous in several respects making it difficult to evaluate the benefits to the U.S. insurance sector and more importantly, making it difficult to implement. We therefore urge the Administration to clarify or confirm certain provisions prior to moving forward with this agreement and asking the States to take on the significant undertaking related to any implementation.

Background

Under the EU's new Solvency II regime, which went into effect on January 1, 2017, an assessment is required to determine whether another country's regulatory system is equivalent to elements of their new regime, and then penalizes that non-equivalent country's insurers with additional regulatory requirements. This has the effect of either imposing the EU approach on the rest of the world, or placing companies from those jurisdictions at a competitive disadvantage when operating within the EU. Last year, certain EU member countries such as Germany and the U.K. began imposing additional regulatory requirements on U.S. companies as they implement Solvency II. Though the materiality of the impact to the U.S. insurance sector does not appear extensive, this is troubling.

The EU may argue that serving as judge and jury of other countries' regulatory systems is an important tool for ensuring emerging markets are safe for EU investment. But the U.S. is the largest market in the world and has proven to be as effective as the best aspirations of Solvency II. Keep in mind, Europe's new system won't be fully implemented for another decade, may undergo further revisions, and has been deemed inappropriate for the U.S. insurance sector by State insurance regulators and the Federal Reserve. We are already subject to assessment and scrutiny by governors' offices, State legislatures, Congress, Government watchdogs, and international standard setters, and our track record of ensuring a competitive and fair market for more than 145 years speaks for itself.

That's not to say U.S. insurance regulators are unwilling to work with our colleagues overseas to address regulatory cooperation and areas of convergence. For several years, we have engaged our EU counterparts on regulatory issues, and to coordinate the oversight of global market players. As part of the U.S./EU dialogue project with Treasury and the EU, we have explored both our regulatory regimes in depth and discovered that despite our structural differences, we have much in common. On the heels of the project, the EU granted provisional equivalence to the United States' group solvency regime—which largely benefited EU insurers—and acknowledged our system's substantial confidentiality protections; all without a covered agreement.

Nevertheless, on November 20, 2015, the previous Administration's Treasury Department and the Office United States Trade Representative (USTR) notified Congress they intended to initiate negotiations to enter into a covered agreement with the European Union to address the disparate treatment of U.S. firms operating in the EU.[1] They made it clear they would not enter into a covered agreement unless terms of the agreement were beneficial to the United States. State insurance regulators were also promised a meaningful role during the covered agreement process. In that notification, the Treasury Department and USTR set out the following negotiating objectives:

[1] Anne Wall and Michael Harney. Letter to Congress Re: Initiation of Covered Agreement Negotiations, 20 Nov. 2015.

1. "treatment of the U.S. insurance regulatory system by the EU as 'equivalent'" under Solvency II "to allow for a level playing field for U.S. insurers and reinsurers operating in the EU;"
2. "recognition" by the EU of the U.S. insurance regulatory system, including with respect to group supervision;
3. "Facilitat[ion of the] the exchange of confidential regulatory information between lead supervisors across national borders;"[2]
4. "nationally uniform treatment of EU-based reinsurers operating in the United States, including with respect to collateral requirements;" and
5. "permanent equivalent treatment of the solvency regime in the United States and applicable to insurance and reinsurance undertakings."

Following notification to Congress, the Treasury Department and USTR negotiated for over a year behind closed doors. Unlike a trade agreement, which is subject to established procedures for consultation, input from the States and a vote by the Congress, there was no formal consultation with a broader group of U.S. stakeholders including industry and consumer participants. State regulators were assured we would have direct and meaningful participation in this covered agreement process, but the few of us involved in the process were subject to strict confidentiality with no ability to consult our staff and fellow regulators, and with little ability to impact the outcome. In fact, even here testifying before this Committee, I cannot identify specific concerns or disagreements that may have occurred during the negotiation. The process was also skewed in favor of the EU from the beginning by the fact that it retained the ability to approve the agreement by the European Parliament and the European Council, whereas the U.S. retained virtually no congressional vetting authority prior to possible preemption of U.S. insurance regulations. Negotiations were completed in January and the Agreement was submitted to Congress on January 13 for the layover period mandated by the Dodd–Frank Act.

An Ambiguous Agreement Is Not an Agreement

Based on a plain reading of the text, we believe the previous Administration's Treasury Department and USTR failed to meet several of their objectives. While we recognize the agreement appears to provide some benefit to certain U.S. insurers operating in the EU by eliminating EU local presence requirements over time, this agreement does not require the EU to grant the U.S. permanent equivalence (or comparable treatment), and in fact, the word "equivalence" is nowhere to be found in the document. This means, even post covered agreement, insurers based in Bermuda or Switzerland, for example, (which have received equivalence) receive greater benefits from the EU than U.S. insurers. Yet, under this agreement, the United States, one of the most sophisticated and well-regulated insurance marketplaces on the globe, continues to be treated by Europe with unjustifiable skepticism. We remain under suspicion, we continue to be monitored, and whatever freedoms afforded by this agreement can be revoked. Similarly, this agreement also fails to grant full "recognition" by the EU of the U.S. insurance regulatory system, including with respect to group supervision. While this agreement appears to prevent the EU from imposing its requirements on the "worldwide parent" located in the United States, it does not provide promised "recognition" or require the EU to recognize the U.S. as equivalent.

While there is little that can be done about the process issues involved in reaching this agreement, this Administration still has an opportunity to address the substantive issues raised by the agreement itself, notably the myriad of ambiguities that exist. Much has been made by former Administration officials about how this is a great deal for the U.S. We would welcome an outcome that benefits the U.S. market and resolves the outstanding issues with finality but in looking at the four corners of the document, it is impossible to know whether we have such an outcome without confirmation from those interpreting it on both sides of the Atlantic. Thus we support the bipartisan requests coming from Congress requesting that the Treasury Department and USTR find some mechanism to resolve these important issues before States are asked to engage in the resource intensive efforts surrounding implementation. Let me provide just some specific examples of a few of the key areas of ambiguity

Overall the language of the agreement is ambiguous as to the obligations of the parties and the entities to which it applies (e.g., the insurance group, the insurance

[2] The agreement encourages, but does not require, supervisory authorities to cooperate in exchanging information while respecting a high standard of confidentiality protection. It appears to do little of substance in relation to laws or procedures related to information exchange.

and non-insurance group, the legal entities, or a combination). The agreement also appears to supersede existing authority of regulators to obtain information or take certain actions currently authorized under State laws. Indeed, there are potential conflicts between provisions and limitations in this agreement and existing State reporting processes as well as critical examination and hazardous financial condition authority. In addition, many key terms describing the circumstances which would prompt action by regulators to comply with this agreement are undefined or ambiguous. For example, the agreement acknowledges a need for a group capital requirement or assessment, but it also requires "the authority to impose preventive, corrective, or otherwise responsive measures on the basis of the assessment, including requiring, where appropriate, capital measures."[3] The provision implies State insurance regulators are effectively required to develop and adopt a group capital requirement, and also includes language suggesting the EU could apply its own group capital requirements and re-impose local presence requirements if States choose not to act. In other words, this agreement seems to compel States to subject a broad group of insurers to additional regulation with no guarantee the EU ultimately would not apply its own layer of requirements if it finds the U.S. approach to be unsatisfactory.

As currently structured, these ambiguities would have to be resolved by an undefined "Joint Committee" composed of representatives of the U.S. and EU. This agreement does not set forth how many representatives will compose the Joint Committee or indicate which persons or bodies will be represented. Importantly, there is no mention of a role for State insurance regulators, who are charged with implementing much of this agreement and whose laws and regulations may be directly impacted or preempted. If resolution cannot be reached on these ambiguities, this agreement may be voided. Under its terms, the agreement is cross-conditional—if any single provision of this agreement is violated, the other party is not obligated to follow other provisions of this agreement. This framework inevitably will lead to perpetual renegotiation through the Joint Committee and uncertainty for U.S. industry, policyholders, and regulators.

EU Market Access at the Expense of Reduced Reinsurance Collateral

As Congress and the Administration weigh the merits of the agreement, the focus from supporters has been on the perceived benefits of the agreement for the subset of U.S. firms doing business in the EU, but consideration must also be given to what is being given up to achieve that benefit. The one objective met was a key negotiating priority for the EU, total elimination of reinsurance collateral requirements. In fairness, this covered agreement retains a few of the elements from the NAIC's Credit for Reinsurance model laws, including requirements with respect to enforcement of final U.S. judgments, service of process, financial reporting requirements, prompt payment of claims, and solvent schemes of arrangement. These requirements are also applicable to U.S. reinsurers doing business in the EU, and collateral may be imposed if these requirements are not met under a process established in this agreement. However, this agreement does not include a fulsome evaluation of a reinsurer's creditworthiness and despite the Treasury Department having verbally committed it would never accept an agreement which totally eliminates reinsurance collateral, it did exactly that.

Existence of reinsurance collateral provides strong incentives for reinsurers to perform on their obligations and regulatory requirements to protect all insurers, particularly smaller insurers that may not have the leverage to renegotiate and require it contractually from reinsurers with whom they do business. Though we believe it is necessary for counterparties to have "skin in the game" (a lesson the financial system was reminded of during the financial crisis with respect to other financial instruments), we have nevertheless attempted to be responsive to the European insurance industry and Governments who have sought reduction of such requirements. We have worked tirelessly to reduce collateral requirements by amending NAIC's Credit for Reinsurance Model Act to allow for reduction in collateral based on the strength of the insurer and its regulatory regime. The amendments have already been adopted by 39 States representing approximately 70 percent of direct written premium and will become an NAIC Accreditation requirement on January 1, 2019, leading to further adoption by States. Interestingly, even though certified reinsurers will likely have reduced collateral requirements, of the 215 EU reinsurers that we are aware of, only 6 have sought and received certification—the remaining reinsurers have not even filed an application.[4] Under the terms of the

[3] *Bilateral Agreement Between the European Union and the United States of America on Prudential Measures Regarding Insurance and Reinsurance*, January 13, 2017, p. 12.

[4] The States and NAIC has certified 32 reinsurers in total, most of which are Bermuda based.

Agreement, all EU reinsurers, even those that have not applied for certified reinsurer status, will be eligible for zero collateral even though they may not meet existing financial strength and other regulatory requirements. When you consider even significantly reduced collateral protections represent commitments to policyholders and a leverage point for regulators, wiping them out entirely will force regulators to find other mechanisms with which to protect insurers and their policyholders from the risks posed by reinsurance counterparties. This could possibly include additional capital charges or restrictions imposed on ceding insurers. This covered agreement essentially transfers the credit risk of foreign reinsurers to their customers: U.S. insurance companies, and by extension, U.S. policyholders.

In sum, the issues addressed by this covered agreement are a creation of the EU's policy making decisions but they are being solved entirely at the expense of State insurance regulation, U.S. industry, and consumers and regulators. Nonetheless, State regulators are firmly committed to resolving these issues so U.S. firms are not put at a competitive disadvantage when operating in the EU.

Confusion Surrounding the Agreement's Terms

Earlier this year, my colleague and NAIC President Wisconsin Commissioner Ted Nickel testified before the House Financial Services Subcommittee on Housing and Insurance, and detailed our concerns.[5] At that time, given the seriousness of these concerns, we urged renegotiation of the agreement. At the same hearing, former FIO Director Michael McRaith, one of the chief negotiators of this Agreement, testified to what he believed the agreement accomplished, specifically that "the Agreement affirms that the U.S. supervises its insurance sector as the U.S. deems appropriate." He noted it only required States to address collateral requirements in a manner that was supportive of State regulator efforts to implement changes to their credit for reinsurance laws and regulations that would reduce reinsurance collateral, finish our ongoing work on a group capital calculation, and for purposes of group supervision, treat EU-based insurance companies operating in the U.S. as they are treated today. He asserted that the Agreement recognizes the current U.S. insurance group supervision practices, prohibits Europe from extraterritorial application of its requirements on U.S. based holding companies or legal entities, and requires certain EU jurisdictions to immediately lift their requirements that U.S. reinsurers maintain a local presence as a condition of doing business.

Candidly, we were surprised. Mr. McRaith's characterization of the Agreement, if shared by the present Treasury Department and importantly by the EU, is more promising than a plain reading of the text suggests. As such, the focus of our requests to Congress, Treasury, and the USTR has evolved to urge confirmation of some of these key assertions. We want to ensure that all parties agree that we have the deal we've been told we have. We believe that confirmation may be achieved without renegotiation and without undue delay. Critically, however, we believe that these ambiguities must be resolved at the outset of the agreement rather than at some later date through the opaque process afforded by the Joint Committee. It is entirely unacceptable to ask 50 State Governors, legislatures, and regulators to revise some of the fundamental elements of their system based on the informal interpretations of the agreement by a former Treasury official no longer involved in its implementation or interpretation. We have confidence that through the bipartisan efforts of this Congress as well as the commitment of this Administration to ensure the U.S. obtains the best deal possible for our citizens, we can resolve these ambiguities and find a way forward.

The Path Forward

Last week, the NAIC submitted a list of provisions to the Treasury Department, the USTR, and the Congressional Committees of Jurisdiction that we would like clarified before the United States moves forward with implementation of the Agreement. Among those included on the list are:

1. Clarifying that insurance regulators can impose regulatory requirements, other than collateral, to address reinsurance counterparty risk;
2. Clarifying that existing group supervisory reporting requirements under State law continue to apply to EU affiliates of U.S. companies;
3. Clarifying that the NAIC's group capital calculation work would meet the terms of the group capital assessment provisions of the agreement;

[5] United States. Cong. House. Financial Services Subcommittee on Housing and Insurance. Hearing Regarding Assessing the U.S.–EU Covered Agreement. February 16, 2017. 115th Cong. 1st sess. Washington: GPO, 2017 (statement of Ted Nickel, Wisconsin Insurance Commissioner)

4. Clarifying that collateral requirement for current reinsurance contracts will be unaffected and confirmation as to how losses treated prior to a new reinsurance agreement will be treated;
5. Clarify how reinsurance collateral requirements should be addressed prior to the conclusion of the 5-year period for full elimination of requirements.

We urge the Administration, with the direct involvement of the States, to expeditiously provide the needed clarity and comfort now rather than taking an imprudent leap of faith that such clarifications will be "worked out" at a later date through a Joint Committee process. Absent such clarifications, we cannot be assured that State implementation will meet the terms of the agreement and satisfy the current Administration or the EU, potentially putting us in a position of perpetual renegotiations or worse yet, having made changes to State laws and regulations only to have the EU challenge those at later date and revert to treating our companies unfairly. Under these circumstances, it is hard to see how our sector can achieve certainty and finality regarding their concerns. Finally, we request that the Administration confirm State insurance regulators will be included in any joint committee and that insurance regulators from all the States will be consulted on all issues that the committee discusses. As the States are the primary regulators of the insurance sector and would have to implement the provisions of any agreement, our involvement and buy-in is essential to its success.

Conclusion

We remain deeply concerned with the treatment of certain insurers by the EU and we remain committed to resolving these issues. However, it is not in the best interest of the United States insurance sector and policyholders to proceed with implementation of the Agreement without clarification of its ambiguous terms and a clear understanding shared on both sides of the Atlantic. Such confirmation of intent will ensure the EU will not be able to use the agreement's lack of clarity as a means of imposing their regulatory system and ultimately their will on our insurance sector to the detriment of U.S. insurance companies and policyholders. Working together with the Administration and Congress, we believe we can obtain a level of comfort and clarity that will achieve finality and certainty for our sector without sacrificing consumer protections. Thank you for this opportunity to testify today and I would be pleased to take your questions.

PREPARED STATEMENT OF MICHAEL C. SAPNAR

President and Chief Executive Officer, Transatlantic Reinsurance Company, on behalf of the American Insurance Association, American Council of Life Insurers, and the Reinsurance Association of America

May 2, 2017

My name is Michael C. Sapnar and I am President and CEO of Transatlantic Reinsurance Company (TRC) and the immediate past Chairman of the Reinsurance Association of America (RAA). I am testifying today on behalf of my company, the RAA [1], the American Insurance Association [2] (AIA), the American Council of Life Insurers [3] (ACLI) and the Council of Agents and Brokers [4] (CIAB). I am pleased to appear before you today to express our collective full support for the recently concluded Bilateral Agreement between the European Union and the United States of America on Prudential Measures Regarding Insurance and Reinsurance (the "Cov-

[1] The RAA is a national trade association representing property-casualty companies that specialize in assuming reinsurance in the U.S. In 2015, RAA's underwriting members and affiliates had surplus of $194 billion and $125 billion in gross written premiums.

[2] The AIA is the leading property-casualty insurance trade association representing approximately 300 insurers that write more than $125 billion in premiums each year. AIA member companies offer all types of property-casualty insurance, including personal and commercial auto insurance, commercial property and liability coverage, specialty, workers' compensation, homeowners' insurance, medical malpractice coverage, and product liability insurance.

[3] The American Council of Life Insurers (ACLI) is a Washington, D.C.-based trade association with approximately 290 member companies operating in the United States and abroad. ACLI advocates in State, Federal, and international forums for public policy that supports the industry marketplace and the 75 million American families that rely on life insurers' products for financial and retirement security. ACLI members offer life insurance, annuities, retirement plans, long-term care and disability income insurance, and reinsurance, representing 94 percent of industry assets, 93 percent of life insurance premiums, and 97 percent of annuity considerations in the United States. Learn more at *www.acli.com.*

[4] The Council of Insurance Agents and Brokers has 205 members selling 80 percent of domestic commercial property/casualty premiums.

ered Agreement"). I commend Chairman Crapo and Ranking Member Brown for holding this important and timely hearing and welcome the opportunity to address the Banking Committee. I also want to thank the Treasury Department, the U.S. Trade Representative and the participating State regulators for their 13 months of hard work in bringing the Covered Agreement to fruition. Transatlantic Reinsurance Company is a New York domiciled professional reinsurer. TRC is a wholly-owned subsidiary of Transatlantic Holdings, Inc., a Delaware corporation, which is a wholly-owned subsidiary of Alleghany Corporation (NYSE: Y), a Delaware corporation. TRC has over 600 employees worldwide, most of whom are in the United States. TRC is robustly regulated in the United States with New York as its domiciliary regulator and New Hampshire as its group supervisor. TRC is licensed or qualified in every State, the District of Columbia, Guam and Puerto Rico and operates globally through a network of 20 branches and offices and 5 subsidiaries.[5] The worldwide branch structure is a more efficient use of capital because it consolidates assets into one entity to enhance TRC's standing as a potential counterparty for reinsurance transactions.

The Covered Agreement Solves Real Problems Today and Makes U.S. Companies More Competitive

The Covered Agreement is a "win" for U.S. companies doing business in the European Union (EU) and for the U.S. system of insurance regulation. It is also consistent with the current Administration's regulatory policy to "enable American companies to be competitive with foreign firms in domestic and foreign markets, advance American interests in international financial negotiations and meetings, [and] make regulation efficient, effective and appropriately tailored." The Covered Agreement resolves several important prudential issues that are adversely impacting U.S. companies doing business in both the United States and the EU. These issues have been discussed by the parties for years, and in some instances decades, without resolution. The Covered Agreement will provide the following immediate benefits to the U.S. (re)insurance sector:

1. U.S.-based reinsurers can resume doing business in markets where they were excluded because of the January 1, 2016, implementation of the EU's Solvency II regime. This development enables U.S. companies to keep capital and jobs in the United States rather than being forced to create Solvency II compliant branches or subsidiaries throughout the EU to maintain existing business. The Agreement also ensures that qualifying U.S.-based reinsurers will not have to post collateral in the EU.
2. Global group supervision can only be conducted by the home country supervisor: U.S. insurers with EU operating companies will only be subject to worldwide prudential insurance group oversight by their lead U.S. State regulator and not "upstream" supervision by EU Member States. It is estimated that this limitation on the application of Solvency II will save U.S.-based property/casualty and life companies potentially billions of dollars in additional capital and compliance costs.
3. Official acceptance throughout the EU of the U.S. insurance supervisory framework which benefits all U.S.-based insurance groups and provides valuable support for the U.S. regulatory system that can be leveraged in current and future international negotiations and regulatory dialogues. For example, this is important precedent for the argument that the U.S. approach to group capital (including valuation) should be incorporated into the IAIS International Capital Standard as an acceptable approach.

Our strong support for the Covered Agreement is consistent with TRC's equally strong support for the well-tested U.S. State-based insurance regulatory system. The Covered Agreement is a targeted Federal tool that is intended to supplement the State-based regulatory system by dealing with important international regulatory issues that State regulation cannot constitutionally address. No regulatory authority is created at the Federal level and any potential Federal preemptive authority is narrowly targeted.

[5] The branches and/or offices are in: London, Paris, Munich, Zurich, Dubai, Buenos Aires, Panama City, Rio de Janeiro, Hong Kong, Shanghai, Singapore, Sydney, Tokyo, Chicago, Miami, Overland Park, San Francisco, Stamford, Bermuda and Toronto. There are also five subsidiaries: TransRe London Ltd. in the United Kingdom; Calpe Insurance Company Ltd. in Gibraltar; TransRe Zurich Ltd. in Switzerland; Fair American Insurance and Reinsurance Company in New York; and Fair American Select Insurance Company in Delaware.

Transatlantic's EU Issues

As a global reinsurer, TRC specializes in managing risks, most notably natural and man-made catastrophes, for others. The one risk that is difficult to manage, however, is regulatory uncertainty. In our business, regulatory uncertainty leads to lost jobs, increased operating costs, lost growth opportunities and reluctance on the part of new and existing clients to choose us as a service provider.

For over 7 years, TRC has encountered challenges arising from the implementation of Solvency II and the lack of fair treatment for U.S. companies operating in the EU. As early as 2008, TRC was tracking the EU's development of Solvency II and the potential negative consequences for U.S. companies. In testimony to the House Financial Services Committee Subcommittee on Insurance, Housing, and Community Opportunity in 2012, I identified issues that TRC was then having because of the impending implementation of Solvency II. I also testified that, at the same time the NAIC was lowering barriers by revising its Model Credit for Reinsurance Law in 2011 to make it easier for non-U.S. reinsurers to conduct U.S. business, the EU was raising barriers and making it more difficult for U.S. companies to do business in the EU. During the NAIC's deliberations, TRC repeatedly asked State regulators to seek and obtain reciprocity of market access (most particularly the EU) in return for the favorable changes for non-U.S. reinsurers. This did not occur. In 2012, TRC supported the U.S.-EU Insurance Dialogue involving regulators from both jurisdictions. While this process enhanced the mutual understanding of both regulatory regimes, it yielded no tangible results addressing U.S. companies' issues. Instead, TRC's issues in the EU continued, including:

1. TRC was confronted with having to choose between having its local U.K. branch regulated on a Solvency II basis up to the U.S. holding company or forming a Solvency II-compliant entity somewhere in the EU to limit the upstream application of Solvency II to the U.S. operations. In an effort to avoid the upstream regulation, TRC chose to turn the U.K. branch into a subsidiary which required TRC to tie up $500 million in capital in the U.K. This corporate move continues to negatively impact our operating costs. Nonetheless, the U.K. has continued to require more and more from this U.K. subsidiary, including requiring: additional independent directors on the board of our wholly-owned subsidiary; additional local compliance and risk management personnel in addition to our large U.S. home office staff; implementation of a partial internal model to comply with Solvency II; restrictions on various highly graded investments held by the U.K. subsidiary; and the ring-fencing of $800 million in assets to cover the loss reserves accumulated by the branch over a 30-year period of assuming reinsurance without incident. These requirements have cost TRC millions of dollars annually without any additional benefit to our customers. In addition, a concern by clients over TRC segregating its capital to form the U.K. subsidiary (instead of having the security of the company's entire U.S. capital base) has cost TRC business opportunities.
2. In 2014, Poland, citing Solvency II, excluded U.S. Reinsurers from the local market. Much discussion ensued with the Polish regulator regarding this restriction, however, the regulator ultimately deferred to EIOPA[6] for clarification. TRC was able to construct a workaround. Without that workaround, however, TRC, like many other U.S. reinsurers, would have been excluded from the Polish market unless it opened a branch in Poland with its own capital and personnel.
3. In late 2015, the U.K., again citing Solvency II, insisted that all U.S. companies operating in the U.K. needed to be Solvency II compliant up to the ultimate controlling entity or seek a discretionary and revocable "other methods determination" waiver from complying with Solvency II. This was a result of the E.U.'s failure to formally recognize the effectiveness of the U.S. State-based regulatory system for companies that are members of U.S.-domiciled groups.[7] Ultimately, TRC was forced to incur the expense and time to seek a waiver of the group Solvency II requirement under the "other methods determination," which, while granted, will expire on December 2018 unless revoked earlier. If

[6] The European Insurance and Occupational Pensions Authority (EIOPA) is a European Union financial regulatory authority whose responsibilities include microprudential oversight of insurance at the EU level (as opposed to the Member State level). EIOPA is often compared to the NAIC but is different in that it has certain regulatory authorities.

[7] Interestingly, the E.U. deemed the U.S.-based regulatory system equivalent for U.S. subsidiaries of EU-domiciled groups so that those entities did not have to be Solvency II compliant. While U.S. groups were expected to fully comply with Solvency II because of their EU subsidiaries, U.S. subsidiaries of EU groups were exempt from complying with Solvency II.

the Covered Agreement is not signed, TRC will have to seek another waiver request in 2018.

Finally, although not impacting TRC, in late 2015, the German regulator issued a notice stating that after January 1, 2016, U.S.-based reinsurers would no longer be able to operate in Germany on a cross-border basis and would be forced to set up a local branch. This decision was based upon the fact the U.S. has not been deemed "equivalent" under Solvency II. Because TRC has an existing regulated Munich branch, we were allowed to continue writing business. Other U.S. companies, however, lost critical business with little notice. Shortly thereafter, Austria adopted a similar interpretation of Solvency II. Later in 2016, Belgium did something similar, seriously disrupting the annual renewal process for U.S. reinsurers and causing TRC to lose a valuable account. There are at least nine other EU States with similar laws. This uncertainty has a chilling effect on U.S. reinsurers' business and may dissuade current and new customers from doing business with us.

Prompt Signature of the Agreement Is Critical for U.S. Companies

The statutorily mandated 90-day Congressional layover period has expired and the Administration should promptly sign the Covered Agreement. A delay in signature could result in elimination of the benefits U.S.-based companies would receive under the Agreement. As a matter of good faith, the EU is currently forbearing from enforcing its Solvency II rules and regulations on U.S.-based companies doing business in the EU in anticipation of the parties' signature of the Covered Agreement. However, this forbearance is not unlimited. For example, the German regulator (BaFin) advised the U.S. by January 13, 2017, letter (attached), that it would suspend its local presence requirements for U.S. reinsurers while both sides proceeded to finalize the Covered Agreement. The letter states:

> The ongoing future supervisory approach regarding U.S. domiciled reinsurers will heavily depend on the fact whether the EU-U.S. Agreement comes in fact finally into force. This means that BaFin's current statements regarding the treatment of U.S.-domiciled reinsurers on the basis of the EU–U.S. Agreement will not be valid (also in a retroactively sense) anymore if BaFin receives serious statements of one of the final decision-making bodies of both parties that the agreement will not come into force respectively the agreement will fail [sic].

The Covered Agreement's provisions eliminating local presence requirements are the linchpin for U.S. reinsurers to be able to write EU business. If the Agreement is not signed, these U.S. companies will not be able to renew, much less write any new, business in the EU without first going through the regulatory processes necessary to create branches and/or subsidiaries in multiple EU Member States. This not only requires sufficient time but also the relocation of capital and personnel from the U.S. to the EU. Because the annual renewal process begins in early September for January 1 renewals, it is imperative that U.S. companies—and the EU market—have certainty regarding U.S. companies' ability to write business in the EU before that time. If the Agreement is not signed soon, Germany (and the other nine countries that have similar laws) may suddenly decide to enforce their local presence requirements, possibly removing the option for TRC to establish the requisite local presence in time for the 2018 renewal season.

Asserted Challenges to the Covered Agreement Should Not Delay Signature

Several companies contend that before the Covered Agreement can be signed, there must be an "official" clarification of certain terms executed by both the U.S. and the EU. These assertions are not only incorrect, but ignore the procedure set forth in the Agreement to resolve such issues. First, merely asserting something is unclear does not make it so. In fact, the plain meaning of the Agreement's text demonstrates otherwise. The Agreement's language is further reinforced by the National Association of Insurance Commissioners (NAIC) Model Laws and Regulations on which portions of the Agreement were based, the U.S. Treasury Department's January 18, 2017, Fact Sheet (attached), and the European Commission's April 4, 2017, Explanatory Memorandum to the European Council (attached). Second, Section 7 of the Covered Agreement establishes a Joint Committee of representatives from the United States and the EU which shall provide "a forum for consultation and to exchange information on the Administration of the Agreement and its proper implementation." Any questions about implementation can and should be addressed in this forum after the Agreement is signed. We strongly support that State insurance regulators should be included in this forum. Finally, to the extent this proposed "simple solution" to clarify the Agreement is a call to renegotiate the Agreement, this should be rejected as it would erase the benefits to U.S. (re)insurers and return the U.S.–EU relationship to the pre-agreement status quo of regulatory uncertainty.

A. The two key substantive issues addressed by the Covered Agreement do not need clarification:

1. *Group Capital.* Several have asserted that the Covered Agreement mandates a group capital requirement in the U.S., and possibly one that resembles Europe's Solvency II. The language does not support this interpretation. First, Article 4(h) of the Agreement states that for a U.S. or European insurance group to enjoy the benefits of the Agreement, it needs to be subject to a group capital calculation by its home supervisor. This word choice is significant because it specifically contemplates the NAIC's current initiative to develop a group capital assessment or calculation (not a standard or requirement as in the EU). Second, Article 4(h) does not (and legally could not) alter existing State sovereign authority. Third, nothing in Article 4 (or elsewhere in the Agreement) suggests that Solvency II's group capital standards should be imported into the U.S. To the contrary, the Agreement's Preamble reflects a mutual acceptance by the EU and the U.S. of, and respect for, each other's governing insurance financial regulatory architecture.

2. *Prospective Treatment of Reinsurance Collateral Relief.* The Covered Agreement text also does not support the assertion that collateral posted pursuant to existing contracts will be automatically released once the Agreement is signed. Article 3 incorporates text from Section 8(A)(5) of the NAIC's Model Credit for Reinsurance Regulation, which does not allow automatic retroactive changes to existing contractual obligations based upon statutory reductions in collateral requirements. The Covered Agreement and the NAIC Model require changes to existing contracts to reflect changing statutory collateral rules only if amendments to the contracts are material (and, of course, agreed to by both parties). The Fact Sheet underscores the U.S. view: "It is understood that changes to regulatory requirements for posting collateral would not apply to amended agreements unless such amendment constitutes a material change to the underlying terms of the agreement."

B. A few companies also have argued that the Covered Agreement should have achieved an official Solvency II "equivalence" determination for the United States. Although this designation would have bestowed benefits on U.S. companies, it would have placed unacceptable requirements on the U.S. regulatory system. Importantly, State regulators never sought or wanted this solution for a simple reason: Solvency II's statutory equivalence process involves a prescriptive, unilateral evaluation by the EU of another jurisdiction's regulatory regime to assess whether its rules and regulations are "equivalent" (i.e., very similar to) Solvency II. The State regulators understood this when, in July 2014, they advised the EU that the U.S. would not be pursuing "equivalence" because of the significant changes to the U.S. supervisory system such a path would require.[8] The Covered Agreement reflects respect for the State regulators' July 2014 decision as it achieved significant benefits for the U.S. without any requirements that the U.S. adopt any Solvency II requirements. The Preamble of the Covered Agreement makes it clear that the U.S. does not intend to adopt any Solvency II requirements and that the EU understands this: "Sharing the goal of protecting insurance and reinsurance policyholders and other consumers, while respecting each Party's system for insurance reinsurance supervision and regulation." Furthermore, the very structure of the Agreement reinforces this agreed parity between the two regulatory systems as the Parties' obligations and benefits are mutual and cross-conditional throughout the Agreement: both sides must continue to perform their obligations to receive the benefits; if one side does not perform, the other side is relieved of its obligations under the Agreement.

C. Although the process could be improved, the Covered Agreement was negotiated and concluded in accordance with existing law. Process concerns should be addressed but should not adversely impact the decision to sign this Covered Agreement. One process issue that should be addressed is formalizing the role of State insurance regulators, who are essential to the negotiation and implementation of a covered agreement. It is important to note, however, that State regulators did have a formal substantive role in this Covered Agreement process. Former FIO Director

[8] July 11, 2014, letter from NAIC to Jonathan Faull (European Commission) ("As you know, U.S. State insurance regulators are not pursuing an equivalence determination. While it is possible to compare our respective statutory authorities on paper, it would be challenging to conduct a comprehensive comparison of our two regulatory systems in practice until Solvency II is fully operational and the outcomes it produces based on actual experience are better understood.") (attached).

Michael McRaith recently testified at the House Financial Services Committee Housing and Insurance Subcommittee Hearing that State insurance regulators attended and participated, often in person, in every negotiation. He also testified that State regulators promptly received every EU document and that there were conference calls for FIO and USTR to receive their input before documents were sent to the EU. NAIC President Ted Nickel testified at the same House hearing that NAIC suggestions were incorporated into the drafts sent to the EU.

In conclusion, the Covered Agreement addresses bilateral insurance regulatory issues that were creating barriers for U.S. companies in the EU. Although there may be lessons learned about the process, the Agreement is a significant and timely "win" for the competitiveness of U.S.-based insurers and reinsurers, insurance consumers, and the U.S. insurance regulatory system. The Covered Agreement removes regulatory uncertainty for companies and establishes fair terms upon which companies operating in both the EU and the U.S. can do business in these jurisdictions. This was accomplished without importing Solvency II into the U.S., something which could not have been achieved with a Solvency II equivalence determination.

Bundesanstalt für Finanzdienstleistungsaufsicht

BaFin

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13.01.2017
Reference: VA 45-I 2263-2016/0023 (Please quote in your reply)
2017/0083827

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Dear Mr McRaith,

I would like to express again BaFin's serious willingness to apply the rules regarding the suspension of local presence requirement for US-reinsurers in the EU according to the agreement as soon as possible.

However, BaFin is only in the position to agree on this suspension under the condition that the EU-U.S. agreement reaches a certain legally binding status. Based on our current assessment, one can assume that this binding status is reached with the formal exchange of letters signed by the chief negotiators of both parties with the EU-U.S. agreement between both parties. According to my information these signed letters had been exchanged at 12 January. We understand that both sides are now proceeding with their domestic procedures respecting the final text.

We would like to emphasize that after the exchange of the signed letters mentioned above, the ongoing future supervisory approach regarding US-domiciled reinsurers will heavily depend on the fact whether the EU-U.S. agreement comes in fact finally into force.

This means that BaFin's current statements regarding the treatment of US-domiciled reinsurers on the basis of the EU-U.S. agreement will not be valid (also in a retroactively sense) anymore if BaFin receives serious statements of one of the final decision making bodies of both parties that the agreement will not come into force respectively the agreement will fail.

Yours sincerely,

Washausen-Richter
(Deputy Chief Executive Director)

Bilateral Agreement between the European Union and the United States of America On Prudential Measures Regarding Insurance and Reinsurance

[U.S.–EU Covered Agreement]

FACT SHEET
January 18, 2017

The United States has negotiated a covered agreement with the European Union (EU), hereunder referred to as the Covered Agreement. The Covered Agreement affirms the U.S. system of insurance supervision, protects insurance consumers, and provides meaningful benefits for U.S. insurers and reinsurers.

Pursuant to 31 U.S.C. § 314, the Federal Insurance Office (FIO) Act of 2010 authorizes the Secretary of the Treasury (Treasury) and the United States Trade Representative (USTR) jointly to negotiate a covered agreement with one or more foreign governments, authorities, or regulatory entities. A covered agreement is a "written bilateral or multilateral agreement regarding prudential measures with respect to the business of insurance or reinsurance."

On November 20, 2015, Treasury and USTR notified Congress that FIO and USTR would begin joint negotiations with the EU. These negotiations began in February 2016 and concluded in January 2017.

The Covered Agreement limits the worldwide application of EU prudential measures on U.S. insurers operating in the EU, including the elimination of worldwide group capital, governance, and reporting requirements. EU prudential supervision of U.S. insurers will be limited to these insurers' EU operations and activities. Additionally, the Covered Agreement includes state-based reinsurance provisions that build on work largely underway at the state level and are expected to reduce reinsurance costs for primary insurers and improve the affordability and availability of insurance products to personal and commercial insurance consumers.

In the United States, state insurance regulators have general authority over the business of insurance (including reinsurance). The Covered Agreement outcomes affirm the integrated U.S. system of state and federal insurance regulation, including the role of state insurance regulators as the primary supervisors of the business of insurance.

The Covered Agreement addresses three areas of prudential insurance supervision: group supervision, reinsurance, and exchange of information between supervisory authorities. In general, the Covered Agreement terms apply on a mutual basis. The group supervision and reinsurance provisions are conditioned upon one another under the application provisions of the Covered Agreement. Key provisions are summarized below.

<u>Group Supervision</u>

Effective January 1, 2016, the EU began applying a new insurance regulatory framework, known as Solvency II, that exposed non-EU insurers to uncertain, differential and costly regulatory treatment if the insurer's country of domicile is not determined by the EU to have a supervisory system that is "equivalent" to the Solvency II supervisory system. Specifically, under Solvency II, EU supervisors have the ability to apply solvency and capital requirements to the worldwide operations of any U.S. insurer operating in the EU, in addition to worldwide reporting and governance requirements. The Covered Agreement precludes EU insurance supervisors from exercising such authorities over the worldwide operations of U.S. insurers. Without the limitations on such worldwide supervisory authority provided by the Covered Agreement, U.S.-based insurers and reinsurers with EU operations would be subject to regulatory burdens of Solvency II.

Group supervision features of the Covered Agreement include (see Article 4 of the Covered Agreement):

- The group supervision practices described in the Covered Agreement apply only to U.S. and EU insurance groups operating in both territories.
- U.S. insurance groups operating in the EU will be supervised at the worldwide group level only by the relevant U.S. insurance supervisors. EU insurers operating in the United States will be supervised at the worldwide group level only by the relevant EU insurance supervisors.
- U.S. insurance groups operating in the EU will not have to meet EU worldwide group capital, reporting, or governance requirements.
- With respect to risks from outside their territories that threaten operations and activities within their territories, supervisors in both the United States and the EU can request information from insurance groups from the other party, and take appropriate action within their territory to protect policyholders and financial stability.

Reinsurance

Subject to certain conditions, the Covered Agreement eliminates collateral and local presence requirements for U.S. reinsurers operating in the EU insurance market, and eliminates collateral and local presence requirements for EU reinsurers operating in the U.S. insurance market, as a condition for and in connection with regulatory credit for reinsurance.

With regard to collateral requirements, the Covered Agreement builds on the reinsurance collateral reform adopted unanimously by U.S. state regulators in 2011 and implemented in many U.S. states. The Covered Agreement establishes financial strength and market conduct conditions that EU and U.S. reinsurers must meet in order to receive the benefits of the Covered Agreement. These requirements provide a substantially equivalent level of protection for ceding insurers and consumers to that which is currently provided by U.S. state laws regarding credit for reinsurance. Among other conditions, the Covered Agreement provides that an EU-based reinsurer will be eligible for collateral elimination in the United States if that reinsurer meets robust capital and solvency standards, and maintains a record of prompt payments to ceding insurers.

While relief from reinsurance collateral requirements will reduce regulatory burdens for EU reinsurers operating in the United States, the Covered Agreement also relieves U.S. reinsurers from the obligation to establish a local presence—i.e., a branch or subsidiary—in the EU.

Collateral in place and collateral requirements for current reinsurance agreements will not be affected. Collateral requirements will be eliminated only with respect to losses incurred and reserves reported related to reinsurance agreements entered into, renewed, or amended after the date that a state law or regulation conforms to the Covered Agreement. It is understood that changes to regulatory requirements for posting collateral would not apply to amended agreements unless such amendment constitutes a material change to the underlying terms of the agreement. Nothing in the Covered Agreement prevents parties to a reinsurance agreement from negotiating for the inclusion of collateral, or for renegotiating current agreements, as a commercial matter.

Reinsurance features of the Covered Agreement include (see Article 3 of the Covered Agreement):

- The U.S. states have 60 months (5 years) to adopt reinsurance reforms removing collateral requirements for EU reinsurers that meet the prescribed consumer protection conditions. FIO will begin the process of making potential preemption determinations of state laws that are inconsistent with the Covered Agreement terms after 42 months.

- For a U.S. or EU reinsurer, conditions regarding financial strength, market conduct (e.g., whether the reinsurer pays claims promptly), and reporting requirements are the bases for relief from collateral and local presence requirements. Failure to meet these conditions and requirements can result in the reimposition of collateral or local presence requirements. Other conditions for reinsurers include consent to service of process and commitment to the payment of final, enforceable judgments.

- Within 24 months, EU Member States will revise existing laws so that U.S. reinsurers can operate in the EU without establishing a branch or a subsidiary. For those U.S. reinsurers that have not yet established a branch or subsidiary but have been operating in the EU, local presence requirements will not be imposed.

Exchange of Information

The Covered Agreement encourages, in a non-binding manner, insurance supervisors in the United States and the EU to share information. To support such information exchange, an annex to the Covered Agreement includes model provisions for a memorandum of understanding on information exchange that insurance supervisors are encouraged to adopt.

Implementation and Application of the Covered Agreement

The EU Member States will apply the group supervision practices described in the Covered Agreement following signature and the Parties' internal processes required for "provisional application" of the agreement before it enters into force. This is anticipated to take approximately 3 months.

The Covered Agreement includes provisions to ensure adherence to Covered Agreement terms and a mechanism for the United States and the EU to consult as needed. The Covered Agreement sets out, on a provision-by-provision basis, specific timelines for implementation of the Agreement and also establishes conditionality between provisions to avoid the possibility that one Party could provide benefits while the other fails to do so. For example, the United States would not be required to implement the reinsurance collateral elimination provisions of the Covered 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 requirements to U.S. insurers' worldwide operations if the United States does not complete the necessary reinsurance reform within five years. These conditions are established with the aim of ensuring full and timely implementation on both sides.

After five years, when each side has successfully completed its reinsurance reforms and applied group supervision practices consistent with the Covered Agreement, it is expected the outcomes of the provisions will become the steady state between the United States and the EU.

Use of this Fact Sheet

This fact sheet is for informational use only, and is not a legal document. This fact sheet should be reviewed in conjunction with the Covered Agreement, which represents the final legal text negotiated between the Parties, and contains important legal conditions and other terms that are not summarized above.

EUROPEAN
COMMISSION

Brussels, 4.4.2017
COM(2017) 165 final

2017/0076 (NLE)

Proposal for a

COUNCIL DECISION

on the signing, on behalf of the European Union, and provisional application of the Bilateral Agreement between the European Union and the United States of America on prudential measures regarding insurance and reinsurance

EXPLANATORY MEMORANDUM

1. CONTEXT OF THE PROPOSAL

• Reasons for and objectives of the proposal

This proposal derives from a Council decision of 21 April 2015[1] pursuant to which the Commission was authorised to start negotiations with the United States of America (US) for the conclusion of an Agreement on insurance and reinsurance. Pursuant to this decision and the negotiating directives, the European Commission negotiated a Bilateral Agreement with the US on prudential measures regarding insurance and reinsurance in the course of 2016.

This Bilateral Agreement covers three areas, group supervision, reinsurance and exchange of information between supervisors:

- It sets out the conditions for group supervision in both Parties of their respective insurance and reinsurance groups. EU and US insurance and reinsurance groups active in both jurisdictions will not be subject to certain requirements with respect to group supervision for their worldwide activities, but supervisors retain the ability to request and obtain information about worldwide activities which could harm policyholders or financial stability.

- It lays down the prudential conditions to be applied for the removal of local presence and collateral requirements for reinsurers regulated and supervised in the other Party.

- It contains provisions and, in an annex, a model memorandum of understanding for the exchange of information between supervisory authorities in the EU and the US. Supervisory authorities will be encouraged to use these provisions to ensure a high standard of professional secrecy in any exchange of confidential information necessary for carrying out their general supervisory activities.

The Agreement thereby lays down an appropriate prudential framework to be applied to insurers and reinsurers from both Parties.

This proposal for a Council Decision constitutes the legal instrument for the signature and provisional application of this Bilateral Agreement.

• Consistency with existing policy provisions in the policy area

EU legislation in the area of insurance lays down a prudential framework for the protection of policyholders and for financial stability. This Agreement further contributes to ensuring a high level of policyholder protection in the EU, notably via increased cooperation and exchange of information between supervisors, whilst also ensuring that both Parties' duly regulated and supervised insurance and reinsurance undertakings are not subject to undue burden.

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1 Council Decision authorising the opening of negotiations on behalf of the European Union with the United States of America for the conclusion of an agreement on reinsurance, 31 March 2015, ST 7320 2015 INIT.

- **Consistency with other Union policies**

In line with the objectives of the Investment Plan for Europe and the Capital Markets Union, this Agreement will facilitate investment by reinsurers[2].

This Agreement is without prejudice to negotiations on a Transatlantic Trade Investment Partnership with the US.

2. LEGAL BASIS, SUBSIDIARITY AND PROPORTIONALITY

- **Legal basis**

The legal basis for the Union to act is Article 207 TFEU read in conjunction with Article 218(5) TFEU.

- **Subsidiarity (for non-exclusive competence)**

This initiative falls under the exclusive competence of the Union. The subsidiarity principle therefore does not apply.

- **Proportionality**

This EU action, laying down prudential rules for insurers and reinsurers, is in line with the principles of Directive 2009/138/EC of the European Parliament and of the Council[3] ("Solvency II") and does not go beyond what is necessary to achieve its aims.

3. STAKEHOLDER CONSULTATIONS

- **Stakeholder consultations**

The negotiations were conducted in consultation with Member States through the relevant Council special committee (the Council Working Party on Financial Services)[4] and Member States were regularly informed about the progress of the negotiations. The European Parliament has also been informed about the progress of the negotiations[5].

Industry stakeholders on both sides have voiced their support for this Agreement and in particular with respect to the supervision of cross-border insurance and reinsurance groups and for the removal of reinsurance collateral requirements.

- **Collection and use of expertise**

Prior to the start of this negotiation, the EU and the US have been closely following developments in each other's jurisdictions, exchanging information on regulatory developments, and have identified specific aspects of each other's regulatory systems as potentially problematic for insurers or reinsurers operating in the other jurisdiction.

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2 EU reinsurers estimate that they have about $40 billion of collateral posted in the USA, which could be used more effectively in other investments. The opportunity cost is estimated at around $400 million per year.

3 OJ L 335, 17/12/2009, p. 1.

4 The Council Special Committee was consulted on 14 March, 13 June, 29 June, 7 September, 30 September, 18 October, 9 November, 29 November, 9 December, 16 December and 19 December 2016 as well as on 10 January 2017.

5 The Chair and Members of the European Parliament's ECON Committee were debriefed *in camera* on 29 June, 11 October, 16 November and 30 November 2016.

This was in particular conducted through the EU-US Dialogue project, which brought together EU and US officials as well as EU and US supervisory authorities.

The European Insurance and Occupational Pensions Authority participated as an observer to these negotiations.

4. BUDGETARY IMPLICATIONS

No impact on the EU budget.

5. OTHER ELEMENTS

- **Implementation plans and monitoring, evaluation and reporting arrangements**

The Agreement provides for the set-up of a Joint Committee, which will provide a forum for the EU and the US to consult and to exchange information on the administration of the Agreement and its proper implementation.

Member States will also need to undertake the necessary actions to ensure implementation of this Agreement.

- **Detailed explanation of the specific provisions of the proposal**

Article 1 sets out the objectives of this prudential Agreement between the EU and the US, in the areas covered by the Agreement. Article 2 sets out the definitions that apply for this Agreement.

Articles 3 and 4 concern respectively reinsurance and group supervision. After full application of this Agreement, reinsurers of one Party operating in the other Party will not be subjected to any requirement to post collateral or to establish a branch or subsidiary, if they meet the prudential conditions laid down in the Agreement, and insurance groups of one Party operating in the other Party which meet the conditions will not be subjected to a requirement to carry out a group solvency calculation for their worldwide activities nor to other aspects of group supervision for their worldwide activities. Supervisors can exercise group supervision on groups established within the territory of their Party, and can require information to be provided about worldwide activities which risk seriously harming policyholders in their jurisdiction or threatening financial stability, or seriously harm the capacity to pay claims.

Articles 5 and 6, and the Annex, concern exchange of information between supervisors, with the commitment for both Parties to encourage supervisors to cooperate in exchanging information for purposes directly related to the fulfilment of their supervisory functions.

Furthermore, the Agreement provides for the setting up of a Joint Committee to discuss the application and implementation of the Agreement under Article 7, and Articles 11 and 12 provide that the Parties can amend or terminate the Agreement, provided the conditions and procedures set out in those Articles are fulfilled, including mandatory consultation for termination of the Agreement.

Articles 8, 9 and 10 set out when the Agreement will enter into force and become applicable, and they also provide for the provisional application of certain Articles of the Agreement.

The Agreement essentially provides for three modes of application between the Parties:

1. Full application of every Article of the Agreement, which starts on either the date 60 months following the date of signature of the Agreement, or the date of entry into force of the Agreement, whichever is later, and – for Articles 3, 4 and 9 – provided the conditions set forth in Article 10(2)(b) are fulfilled.

   The Agreement remains in full application unless it is terminated in accordance with Article 11.

2. Where entry into force of the Agreement is prior to the date 60 months following signature of the Agreement, certain parts of the Agreement start to apply on earlier dates:

   Article 7 [Joint Committee], Article 11 [Termination and Mandatory Consultation] and Article 12 [Amendment], apply as from the date of entry into force of the Agreement. Article 4 is also to be applied from that date, in accordance with Article 10(2)(a) by the EU, and on a best efforts basis for the US side.

   Article 3(1) and (2) apply with respect to EU reinsurers in a U.S. State as from the date of either the adoption by the US State of a measure consistent with those provisions, or the date at which any pre-emption determination becomes applicable, pursuant to Article 10(2)(d).

   Finally, Article 3(3) shall be implemented and applicable in the EU as from 24 months after the date of signature, pursuant to Article 10(2)(g).

3. Prior to the entry into force of the Agreement, certain parts of the Agreement will also be provisionally applied. This provisional application concerns the following Articles:

   – Article 4, in accordance with Article 10(2)(a), and

   – Article 7.

   Provisional application starts on the seventh day of the month following the date on which the Parties have notified each other that their internal requirements and procedures necessary for provisional application have been completed. It lasts until the date of entry into force of the Agreement (or until one Party notifies the other Party of its intention not to complete its internal requirements for the entry into force of the Agreement).

Annex I of the Agreement contains detailed provisions for a Memorandum of Understanding for the exchange of information between supervisors, which the Parties shall encourage supervisors on both sides to follow pursuant to Article 6 of the Agreement.

2017/0076 (NLE)

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COUNCIL DECISION

on the signing, on behalf of the European Union, and provisional application of the Bilateral Agreement between the European Union and the United States of America on prudential measures regarding insurance and reinsurance

THE COUNCIL OF THE EUROPEAN UNION,

Having regard to the Treaty on the Functioning of the European Union, and in particular Article 207 read in conjunction with Article 218(5) thereof,

Having regard to the proposal from the European Commission,

Whereas:

(1) On 21 April 2015, the Council authorised the Commission to open negotiations with the United States of America for an Agreement on reinsurance[6]. The negotiations were successfully concluded by an exchange of letters between the lead negotiators on 12 January 2017.

(2) The Agreement should be signed on behalf of the European Union, subject to its conclusion at a later date.

(3) In view of enabling the set-up of the Joint Committee under this Agreement, which will provide a forum for the EU and the United States of America to exchange information on the proper implementation of the Agreement and in order to allow for the implementation of harmonised practices by supervisory authorities in the EU as regards group supervision which are already possible under the current EU legal framework in this area, Articles 4 and 7 of the Agreement should be applied provisionally,

HAS ADOPTED THIS DECISION:

Article 1

The signing of the Bilateral Agreement between the European Union and the United States of America on prudential measures regarding insurance and reinsurance is hereby approved on behalf of the Union, subject to the conclusion of the said Agreement.

The text of the Agreement to be signed is attached to this Decision.

6 Council Decision authorising the opening of negotiations on behalf of the European Union with the United States of America for the conclusion of an agreement on reinsurance, 31 March 2015, ST 7320 2015 INIT.

Article 2

The Council Secretariat General shall establish the instrument of full powers to sign the Agreement, subject to its conclusion, for the person(s) indicated by the negotiator of the Agreement.

Article 3

Articles 4 and 7 of the Agreement shall be applied provisionally in accordance with Articles 9 and 10 of the Agreement.

Article 4

This Decision shall enter into force on the day of its adoption.

Done at Brussels,

For the Council
The President

National Association of Insurance Commissioners & The Center for Insurance Policy and Research

July 11, 2014

Mr. Jonathan Faull
Director General, Internal Market and Services
European Commission
1049 Brussels
Belgium

Dear Mr. Faull:

Thank you for your letter of June 6th regarding your views on the "Way Forward Project" and for your assessment of the US regulatory system in the context of the Solvency 2 equivalence requirement.

We agree that the Project has been useful in terms of enhancing mutual understanding of the US and EU regulatory systems. As our collective jurisdictions represent nearly two-thirds of the global insurance market, shared confidence in our different regulatory approaches is important to reinforce the transatlantic insurance market and ensure effective cross border supervision of global firms.

As you know, U.S. state insurance regulators are not pursuing an equivalence determination. While it is possible to compare our respective statutory authorities on paper, it would be challenging to conduct a comprehensive comparison of our two regulatory systems in practice until Solvency 2 is fully operational and the outcomes it produces based on actual experience are better understood.

There are clear structural and legal differences between our two supervisory systems, but we continue to believe that the US regulatory system results in outcomes for insurers and policyholders that we hope Solvency 2 will achieve once it is fully implemented. This belief is based on real experience during periods of recession and great stress, hard and soft markets, low interest rates, and increasing frequency and severity of catastrophic events. Irrespective of those views, any inflexibility in the equivalence process that precludes the Commission from reaching a similar conclusion about the efficacy of our system is entirely self-imposed. Equivalence is a function of European law subject to the Commission's interpretation, so in lieu of delineating changes to the US supervisory system that by all accounts is among the most effective in the world, the Commission should instead reevaluate whether the equivalence mandate deserves to be reconsidered given its potential negative impact on US and European firms and policyholders.

Sincerely,

Membership of the NAIC International Insurance Relations Leadership Group

Senator Ben Nelson
NAIC CEO

Adam Hamm, Chair
NAIC President
North Dakota Insurance Commissioner

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July 3, 2014
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PREPARED STATEMENT OF STUART HENDERSON

PRESIDENT AND CHIEF EXECUTIVE OFFICER, WESTERN NATIONAL MUTUAL INSURANCE COMPANY, ON BEHALF OF THE NATIONAL ASSOCIATION OF MUTUAL INSURANCE COMPANIES

MAY 2, 2017

The National Association of Mutual Insurance Companies (NAMIC) is pleased to provide comments to the Senate Committee on Banking, Housing, and Urban Affairs on the recently completed U.S.–European Union (EU) covered agreement dealing with insurance regulation. We appreciate the Committee'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, 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.

The agreement had a 90-day layover period in Congress that ended April 13. This was intended to provide lawmakers the opportunity to review and provide comment on the agreement. However, the agreement does not require congressional approval. Treasury and USTR have not yet decided to sign the agreement or take other action. This 90-day period began to run 7 days before President Trump 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 hold off signing the agreement until important ambiguities are clarified. If these issues cannot be adequately resolved, the Administration should 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 prior Administration, on Friday, January 13, 2017, the 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 if 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 through 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 that they must post collateral in the U.S. to protect ceding insurers ability to collect when due reinsurance recoveries. This problem was addressed by the NAIC in their 2011 revised model Credit for Reinsurance Act. That model act 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 39 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. In exchange for the elimination of $40 billion of reinsurance collateral requirements for EU reinsurers, the EU has only agreed to return to the pre-Solvency II status quo when they were not unfairly punishing U.S.-based (re)insurers for the U.S. State laws.

The Covered Agreement

The covered agreement allows for a period of 5 years for each jurisdiction to revise laws and regulatory practice to 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

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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.

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: (1) what they can count on from the EU insurance supervisors; (2) if U.S. regulators will meet the obligations they were not involved in negotiating; and (3) whether they will be disadvantaged by one of the many exceptions to the agreement. 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 within 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 enact laws and regulations reflecting this EU reinsurer zero-collateral requirement within 5 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-in the U.S., both small and large, 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 pay the money owed to policyholders in a timely fashion in the event of natural catastrophes or other large loss events. The elimination of required collateral particularly disadvantages smaller insurers that are more reliant on reinsurance. And though the agreement provides no prohibition on negotiating for collateral in reinsurance contracts, 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, those benefits are exaggerated and in many cases lessened by the exceptions and ambiguous language in the document.

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, or doesn't decide to add, a similar requirement for the domestic EU companies. In addition, it is important to note that if the agreement fails or terminates, EU supervisors will be able to undo forbearance of these local presence demands, while the revised State laws/regulations eliminating reinsurance collateral will have to be repealed by all State legislatures. 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, and the U.K. is positioning themselves for a similar agreement after Brexit removes them from the EU. This could be the beginning of zero collateral for all non-U.S. reinsurers. This would ignore the work State regulators and 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-nine States have already acted to enact this 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 the U.S. in order to gain acceptance of the existing U.S. 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, with exceptions. 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 5 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 uses §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 about both 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 add to the perception that this is intended to be an ongoing evaluative process with 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 new group supervision and future regulatory uncertainty. It is also a bad deal for consumers in America who ultimately pay for 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, those companies threatened by increased 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, it might involve negotiating a mutual recognition provision in a future trade agreement or at least clarifying the intention of the covered agreement to provide such recognition. NAMIC believes that the U.S. ought to be able to request new language in the agreement or at least letters clarifying the intention of the agreement to assure our insurance and reinsurance markets can continue to function without unfair barriers to trade.

In the end, if necessary, Congress should not hesitate to urge the Trump administration to go back to the drawing board and secure a better deal. A real solution must meet the needs of the insurance-buying public, the insurance industry, and State regulators—the current covered agreement does not meet those needs. NAMIC

[2] Ibid.
[3] Ibid.

appreciates the opportunity to testify and looks forward to working with the Committee going forward.

PREPARED STATEMENT OF DAVID ZARING

ASSOCIATE PROFESSOR OF LEGAL STUDIES AND BUSINESS ETHICS, THE WHARTON SCHOOL, UNIVERSITY OF PENNSYLVANIA

MAY 2, 2017

I am an associate professor of legal studies and business ethics at the Wharton School. I study financial regulation and, in particular, international financial regulation, a field of growing importance and one that has already transformed the way that banks and capital markets are regulated. It is a field of increasing importance to insurance as well.

Overview

In my testimony today on the covered agreement between the United States and the European Union, I would like to focus on three points.

First, the covered agreement grew out of an effort in the wake of the financial crisis to improve the regulation of financial companies, including insurance companies, given the repercussions of the failure of the large insurance company AIG during that crisis. For insurance, that effort has involved a number of different channels. The goals have been twofold. One has been to make sure that globally active insurance companies are sensibly regulated as whole enterprises, rather than as a series of operating subsidiaries in a variety of different jurisdictions. The second has been to insure that internationally active insurance companies have faced a level playing field when it comes to doing business at home or overseas.

The covered agreement complements efforts to reduce nontariff barriers through trade agreements and efforts to increase the quality of global insurance supervision through organizations like the International Association of Insurance Supervisors (IAIS). It offers the reduction of two barriers to trade and two regulatory agreements that will improve the supervision of insurance conglomerates in both the United States and Europe, serving objectives identified by regulators and trade negotiators in the wake of the financial crisis.

Second, the agreement deepens cooperation through the exchange of information, includes a deal on reinsurance that reduces trade barriers in both the United States and the European Union, and provides a sensible framework for the supervision of insurance conglomerates as groups. As a matter of content, it is likely to be good for insurance companies and consumers. In addition, it rationalizes the supervision of insurance companies by looking at the totality of their operations, just as banking supervisors do when it comes to banking financial conglomerates.

Third, the critics of the transparency of the process in concluding the covered agreement are misguided. The United States never hid the fact that it was engaging in negotiations with the European Union, and now that the result of those negotiations have been made public, the covered agreement is being appropriately reviewed by Congress and by stakeholders. That is the right way to contact transparent international processes: congressional approval to engage in international negotiations is given beforehand, and the results of those negotiations are reviewed after the fact. Requiring more and different consultations during the negotiations would be both inconsistent with the way negotiations work and entirely unnecessary process.

More generally, international regulatory cooperation is not easy, and must be paired with procedural protections, but the United States cannot ignore the efforts and interests of foreign regulators. The global effort to create a single common set of accounting standards exemplifies the risks of failing to engage. The United States stayed out of that process, but the resulting International Financial Reporting Standards have now been adopted by essentially every jurisdiction in the world but one—and the Securities and Exchange Commission is now accepting IFRS for foreign filers. This country can take a leadership role in devising international regulatory standards, or it can let others develop the standards, and adopt them later. But it cannot ignore them.

The Context for the Covered Agreement Between the U.S. and EU

Before the financial crisis, insurance companies were thought to be relatively safe financial intermediaries. They were regulated, especially in the United States, more to ensure that they did not deceive consumers, rather than for the danger that they would collapse and create risks for the financial system. That perspective made sense in most contexts; insurance companies are less susceptible to bank runs or the sort of operational risks posed by rogue traders or flash crashes that may roil the financial and capital markets. State insurance commissioners have traditionally led the way in this oversight.

However, the financial crisis exemplified the ways that, as insurance companies have taken on more varied operations, their conduct can threaten the stability of the system. Most notably, this occurred in the case of the insurance giant American International Group, one of the largest companies in the country. As you all know, it collapsed in 2008. AIG provided all sorts of insurance to policyholders all over the world. But its diverse array of products proved to be its undoing; AIG was ruined by a combination of the entry into a new quasi-insurance market, and the dependence on a securities lending program that dried up just as the new business started to fare disastrously.

The new business was run out of AIG's London subsidiary, AIG Financial Products. AIG–FP wrote insufficiently hedged credit default swaps, bolstered by the strong balance sheet of the larger insurance firm. As the credit crisis worsened, AIG had to post more and more collateral to satisfy its counterparties that it would make good on the credit protection contracts it had written. Eventually the need to post ever more collateral rendered the company essentially insolvent, with a large proportion of its assets encumbered. Some accounts put the losses on this credit insurance at $30 billion.

To make matters worse, AIG's securities lending business collapsed at the same time and for largely the same reason: the collapse in mortgage backed-securities markets. Companies like AIG that hold a lot of securities against the insurance policies written by their operating subsidiaries often lend the securities out in exchange for cash collateral. When they do so, they typically take that cash collateral and invest it in something short term and relatively safe. But AIG invested in riskier assets, including assets backed by subprime residential mortgage loans. When the financial crisis began to deepen, and borrowers returned their securities, seeking the cash collateral, AIG found itself unable to liquidate these assets quickly, at the price the firm expected to receive. Estimates at the losses due to this securities lending have placed that deficit at around $21 billion.[1]

The result was that a famously careful American insurer that served different customers across the world was undone by one relatively small London subsidiary, which, it turned out, was not being carefully overseen by British insurance regulators, the New York insurance commissioners who oversaw the center of the firm's operations, or the Office of Thrift Supervision, which oversaw AIG to the extent that the conglomerate served as a holding company of a thrift subsidiary. Its overseers had also not realized that it had found its way into a runnable market through its securities lending business. The securities held by its insurance subsidiaries had been lent out through a process centralized through a noninsurance, securities lending-focused subsidiary.

Both disasters, which hit AIG at the same time, posed problems that the company's insurer supervisors were ill-equipped to solve or even recognize in part because they did not subject the firm to meaningful consolidated, or group level, supervision.[2] Instead the various subsidiaries of AIG were parceled out as the responsibility of various regulators, with little effort made to coordinate that supervision.

The AIG experience, and the financial crisis in general, changed the way that oversight over nonbank financial companies was allocated between the States and the Federal Government, particularly with regard to the effort to create international standards. Title V of the Dodd–Frank Wall Street Reform Act created the Federal Insurance Office (FIO) within the Department of Treasury. That office has limited powers, especially domestically, where insurance supervision remains the province of the State insurance commissions. FIO has nonetheless been charged with a particularly important outward-facing role. It has unique international responsibilities: Congress instructed it "to coordinate Federal efforts and develop Federal policy on prudential aspects of international insurance matters, including representing the United States, as appropriate, in the International Association of Insurance Supervisors;" (IAIS) to "consult with the States (including State insurance regulators) regarding insurance matters of national importance and prudential insurance matters of international importance;" and to "advise the [Treasury] Secretary on prudential international insurance policy issues."[3]

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[1] For a discussion, see Robert McDonald and Anna Paulson, "AIG in Hindsight", 29 *J. Econ. Persp.* 81 (Spring 2015).

[2] For a further discussion of the AIG problem, see Daniel Schwarcz, "A Critical Take on Group Regulation of Insurers in the United States", 5 *UC Irvine L. Rev.* 537 (2015).

[3] 31 U.S.C. §313(c).

It also has been given the power, in association with the United States Trade Representative, to conclude agreements on insurance regulation with foreign counterparties.

These so-called covered agreements are defined in Dodd–Frank as

> a written bilateral or multilateral agreement regarding prudential measures with respect to the business of insurance or reinsurance that is
>
> (A) entered into between the United States and one or more foreign Governments, or regulatory entities; and
>
> (B) relates to the recognition of prudential measures with respect to the business of insurance or reinsurance that achieves 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. [4]

These covered agreements are meant to both strengthen insurance regulation and level the playing field between the United States and other countries, and are meant to serve as a bilateral backstop for regulatory cooperation in cases where multilateral regulation has not made progress. An analogy might be drawn to this country's approach to progress on reducing barriers to trade. When multilateral agreements like the Doha Round have foundered, the United States has increasingly looked to pursue its trade interests through regulation or bilateral trade and investment deals. In the case of post-crisis insurance supervision, the hope evinced in Dodd–Frank is that where multilateral efforts to either level the international playing field or to improve the supervision of systemically risky insurance companies has foundered, bilateral covered agreements might serve as a useful supplement.

The work of IAIS continues and, of course, trade negotiations, on both the bilateral and a multilateral basis, are part of the mix that will affect the playing field on which insurers from a variety of different jurisdictions can seek to market their products to consumers both at home and abroad.

In my view, the covered agreements occupies a place in the middle of these international efforts to solve some of the problems posed by the modern insurance market. On the one hand, trade negotiations are about reducing trade barriers and making it more possible for insurance companies to access foreign markets. Trade uses its national treatment principle to do so—that principle provides that members of the World Trade Organization "shall accord to the nationals of other Members treatment no less favorable than that it accords to its own nationals" for a variety of products and services. [5] The goal is to remove discriminatory regulation of foreign imports as much as possible.

The IAIS efforts are also designed to level the playing field when it comes to the supervision of insurance companies. Here, the effort is not so much to remove regulations as it is to improve them. International financial regulation through a network like IAIS in this way has a harmonizing purpose just like trade agreements, but IAIS seeks to bring regulatory standards in member countries up to a more intensive standard, with national treatment serving as both a justification (we must measure up to the other members of the network in our treatment of our insurers) and a caution (we must treat our insurers the same way we treat foreign insurers) for more intense oversight. [6]

In the wake of the financial crisis, IAIS, and the coordinator of financial oversight, the Financial Stability Board, under instruction from the G20, has taken new steps to create consistent global standards for supervisors designed to improve the safety and soundness of financial firms, including capital standards and group standards.

Efforts to create international insurance standards make sense as American firms increasingly enter foreign markets, and foreign firms enter the American one. Common standards level the playing field, and invite the sort of competition that can only benefit insurance consumers. And in a world where an insurance group can be destabilized by a faltering subsidiary in a single country, the value of coordinated supervision is obvious.

Nonetheless, international processes are almost by definition more difficult to follow than domestic ones. IAIS and the FSB have taken, often at the behest of American regulators, steps towards improving their transparency. They have websites, they issue consultative documents and accept comment upon them, and they hold

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[4] 31 U.S.C. §313(r)(2).

[5] GATT Article III.

[6] A further discussion of this point may be seen in David Zaring, "Finding Legal Principle in Global Financial Regulation", 52 *VA. J. Int'l L.* 685, 707 (2012).

increasingly open annual meetings. And the IAIS has usefully dropped the very high fee it required of those who hoped to attend its annual meeting. But transparency should not be viewed as requiring that any and every interested party be able to attend any meeting at any moment. No business works that way, and nor does any agency. Policymaking requires opportunities for deliberation, and the importance of a role for deliberation should not be gainsaid.

The covered agreement between the United States and the European Union occupies a middle ground once this context is taken into account. On one hand, the portion of the agreement that deals with reinsurance reduces trade barriers in both the European Union and the United States. On the other hand, the group supervision agreement improves the quality and consistency of the supervision of insurance conglomerates by encouraging regulators to assess the solvency and capital adequacy of insurance companies at the group level, rather than solely at the operating subsidiary level.

Finally, I think it would be remiss not to observe that the agreement provides for an information exchange that is likely to deepen the contacts between regulators in the U.S. and EU in a way that will be a great benefit the next time that a large insurance company runs into financial trouble.

The Content of the Covered Agreement

Once the context of the covered agreement is understood, its content makes a great deal of sense.

The reinsurance portion of the agreement reduces trade barriers in both the United States and the European Union in a way likely to benefit American consumers. I therefore view it as something like a trade deal, contained within the more narrow confines of a limited agreement on international insurance regulation. In particular, the requirement that foreign reinsurance firms post 100 percent collateral to do business in certain American jurisdictions makes little sense for well supervised European reinsurers. This problem has been apparent for years, and yet any reduction in the collateral requirements, which thereby would open up the U.S. reinsurance market and introduce new competitors, to the benefit of insurance companies and ultimately consumers, has been slow.

The agreement would prevent U.S. State insurance regulators from requiring EU reinsurers to post such high levels of collateral as a condition for U.S. firms to be credited for their contracts with EU reinsurers. These provisions do not limit the power of American regulators to apply requirements for entering into reinsurance agreements. The Treasury Department views this requirements as one that builds on the reinsurance collateral reform adopted unanimously by U.S. State regulators in 2011 and implemented in many, but not all, States. I am inclined to agree.

In addition to improving the reinsurance market, the rationalization of reinsurance collateral requirements will likely help the United States as it pursues further nontariff barrier concessions from the European Union. The participation of the USTR in the negotiations over the covered agreement underscores the relevance of the reinsurance arrangements for the more general reduction in trade barriers on both sides of the Atlantic.

The United States also got something for American reinsurance companies as well. One of the covered agreement's objectives, as announced in its Article I, is "the elimination, under specified conditions, of local presence requirements." Specifically, the agreement relieves U.S. reinsurers from the obligation to establish a local presence—i.e., a branch or subsidiary—in the EU. The local presence requirement in the EU was also a real burden on the ability of American reinsurers to access that market. The elimination of that burden will level the playing field for American and European reinsurance firms by making it easier for American reinsurers to access the European market without opening an office in every jurisdiction in which they do business.

The agreement also contains provisions on group supervision. Under the EU's "Solvency II" regime, European insurers are subject to group supervision, and foreign insurers seeking to do business in the EU are required to establish that they are supervised in a comparable way. Most worryingly for American firms, the EU reserved for itself the right to impose additional capital and other regulatory requirements on firms if its country of domicile was not determined by the EU to have a supervisory system that is "equivalent" to the Solvency II supervisory system.

The covered agreement provides that this requirement will not be imposed upon American insurers doing business in Europe, provided that they can establish that they are being adequately supervised as groups. The agreement was in this way designed to "establish[] that the [American] supervisory authority, and not the [European] supervisory authority, will exercise worldwide prudential insurance group supervision," as the agreement provides in Article I. It means that U.S. insurance groups operating in the EU will be supervised at the worldwide group level by the relevant U.S. insurance supervisors, rather than through a European process imposed on American insurers and based on Solvency II.

Group supervision is, in my view, the appropriate way to supervise any large financial conglomerate. Banks are supervised at the holding company level by the Federal Reserve, and the single point of entry resolution scheme also looks to manage firms in crisis in a consolidated way. Dodd–Frank, in the way it treats nonbank subsidiaries of broker dealers and derivatives desks also looks to the group rather than the operating subsidiary in assessing systemic risk.

The group supervision component of the covered agreement brings this sort of focus to insurance conglomerates, and appropriately so. I have observed that some of the problems posed by the supervision of AIG were likely attributable to the fact that its American regulators were not sufficiently focused on its London financial products affiliate, as well as on its non-insurance securities lending affiliate. It makes sense to assess the riskiness of an insurance company with a view to the whole insurance company, and not by only looking at its operating subsidiaries on a State-by-State basis.

Moreover, it appears that the approach taken in group supervision of insurance conglomerates mimics the program that the National Association of Insurance Commissioners is already rolling out. State regulators used to regulating firms at the operating subsidiary level are unaccustomed to group supervision, and may not have the incentives to cooperate in a way likely to make group supervision successful. They are, however, beginning to address the issue with their "windows" and "walls" approach to groups. The "walls" of the State regulatory process are designed to ring-fence individual regulated entities from various risks that may be associated with their affiliates or holding companies, and include rules requiring that insurers' transactions with affiliates be on terms that are "fair and reasonable" and subject to regulatory disapproval. The "windows" of U.S. insurance regulation are designed to allow regulators of individual operating entities to assess potential risks from affiliates that may impact the operating entity. The "windows" provide regulators with financial information from any entity controlling the insurer, financial statements of all affiliates, and the right to acquire information seek further information about large risks faced by the insurance group.[7] The covered agreement recognizes this approach, as well as the Own Risk and Solvency Assessment used by State regulators, which would be shared with European regulators.

Finally, the agreement provides for an information exchange that will amplify and improve contacts between regulators in the U.S. and EU. Over four decades of cooperation among central bankers and securities regulators has contributed to the capacity for the coordinated response that we have seen, to the degree that we have seen it, in the response to the last crisis, by both. In the midst of that crisis, the Securities and Exchange Commission coordinated its shorting ban with its international counterparts at an International Organization of Securities Commissions (IOSCO) meeting, even though the coordination was done in the hallways rather than during the official session. By the same token, the coordination of the injections of capital through swap lines and other mechanisms by the world's central bankers was facilitated by their already extant supervisory cooperation. In other words, cooperation on matters of enforcement and understandings along those lines can create or further the relationships that can facilitate an international response to the next crisis.[8] That precedent is why I view the agreement on information exchange as a worthy and useful aspect of the agreement.

Finding the Right Level of Transparency for the Covered Agreement

How can we ensure that the sorts of international processes represented by the covered agreement have the right amount of accountability and democratic legitimacy? At best, Congress will begin the process by authorizing, or in some cases blessing, efforts at international regulatory cooperation. Second, the regulators will engage in that cooperation. And finally, regulators must come engage in a domestic administrative process.

So far, this is the process that has been followed in the covered agreement. Congress gave Treasury and the USTR the power to negotiated covered agreements in Dodd–Frank. And American regulators participating in the process notified Congress and the industry before they began to negotiate an agreement with their European counterparts, and provided updates over the course of the negotiation.

[7] For an overview of these rules, see Daniel Schwarcz, "A Critical Take on Group Regulation of Insurers in the United States", 5 *UC Irvine L. Rev.* 537 (2015).

[8] For more on this, see David Zaring, "International Institutional Performance in Crisis", 10 *Chi. J. Int'l L.* 475, 485 (2010).

Complaining about the transparency of the negotiations as they are happening is, in my view misplaced, provided there is a full and fair opportunity to review the product of those negotiations. This hearing is part of that review. Too many consultation or participation requirements limit the ability of negotiators to in fact negotiate.

Finally, the text of the final agreement was sent to all of the relevant committees as required by Dodd–Frank. There is much process required before the U.S. can take action against any State that fails to bring its rules into line with the covered agreement:

- No later than 42 months following execution of the Agreement, the U.S. must begin evaluating potential preemption determinations with respect to any State insurance measure that results in less favorable treatment of an EU insurer or reinsurer than a U.S. insurer or reinsurer in a manner inconsistent with the agreement. The U.S. has agreed to consider the States with the biggest reinsurance market first, and to finish within five years following execution of the agreement.
- If it makes a preemption determination, Treasury must notify and consult with the State insurance regulator, take comment on the proposed determination, and give the State some time before finalizing preemption.
- A State has the right to challenge that preemption determination in court.

Covered agreements are meant to strengthen insurance regulation and level the playing field between the United States and European Union. There has been talk in the past about pre-conclusion publication requirements, or elaborate rounds of comment, sometimes involving congressional committees, before beginning the process of negotiating the agreement. But requiring draft agreements, or the American negotiating position, to be published in the *Federal Register* simply slows the process of implementing these agreements. It also suggests that the United States might not be able to live up to its bargains, which makes these agreements—which were blessed by Congress in Dodd–Frank—all the more difficult to conclude. It is also, for that matter, no way to conduct an international negotiation—you don't reveal your hand before you head to the bargaining table.

The Risks of Non-Participation: The International Accounting Standards Saga

In my testimony, I have emphasized that international regulatory cooperation provides opportunities for American regulators to improve the stability of the financial system at home, and abroad, and therefore better meet their domestic regulatory mandates. I'd like to conclude with a cautionary tale about what can happen if American regulators reject an international process.

The accounting story is particularly instructive. It is a cautionary tale for Americans because American regulators, by essentially abandoning an already ongoing harmonization effort in the 1990s, lost their ability to affect the effort, and now have had to begin the process of conforming to it.

International accounting standards—the idea that companies listed on stock exchanges from Stockholm to Shanghai might report their results in the same way—have always been an attractive regulatory goal. In the 1980s, capital market regulators agreed to endorse an effort by professional accounting organizations to try for global harmonization of accounting rules. But the effort proved controversial, as American regulators comfortable with the unique American approach to financial statements withdrew their support for the enterprise in the early 1990s.

That exit, however, did not stop the process of devising common accounting standards. Instead, the international efforts moved to Europe; the creation of international accounting standards after the SEC's rejection of the prospect of them, has been managed by the International Accounting Standards Board (IASB), a public–private arrangement based in London created in 2001. The IASB has devised a set of accounting standards, the International Financial Reporting Standards (IFRS), which has enjoyed quick adoption in European and other countries. IFRS was essentially created without American participation.

And therefore, perhaps unsurprisingly, IFRS is rather different from American accounting rules. It is a principles—rather than rules—based accounting system, in that it is less technical than traditional American accounting, and relies more on the gestalt of a company's returns to assess its accuracy. The United States had—and, for the moment, still has—a unique rules-based and reputedly challenging set of accounting standards that differ greatly from those of any other Nation, the Generally Accepted Accounting Principles (GAAP).

But, faced with a cascade of adoptions of IFRS, those GAAP principles have a very tenuous future, despite the SEC's doubling down on their necessity in the 1990s.

As foreign jurisdictions have gained more and more of the business of floating stocks and bonds and raising capital, American capital market regulators have given up hope that they might do so in ways consistent with the complicated GAAP. The SEC has permitted foreign companies that list on American stock markets to use IFRS to file their American annual and quarterly reports. And the SEC will surely accede to IFRS eventually for all filers.

Accounting is technical, and acronyms like GAAP and IFRS daunt almost as much as they reveal what, exactly, the distinction between rules-based and principles-based accounting really amounts to. But the import of the triumph of IFRS can be gleaned by abstracting away from it, and from the details of accounting. The commitment to an international effort in accounting has worked a sea change in the way that companies report their results, and the sea change has come without much American involvement—even though it will, in the near future, affect American companies as much as anyone else.

Thus, this story of accounting standards illustrates what happens when international efforts are not pursued, even though safeguards on cooperation are important. Its propensity towards momentum is not a universal law, to be sure, but regulators ignore cross-border efforts at their peril, because those efforts can set the standards for even the most independent and recalcitrant jurisdictions, if the circumstances are right.

Thank you.

RESPONSES TO WRITTEN QUESTIONS OF SENATOR CORKER FROM MICHAEL T. MCRAITH

Q.1. There was some discussion during the hearing about potential opportunities to enhance the process for soliciting State insurance regulators and other stakeholders' input in connection with future Federal Insurance Office-led negotiations of covered agreements. Could you describe with some additional detail how that process should be enhanced in future negotiations?

A.1. Response not received in time for publication.

Q.2. How should the Joint Commission process work to ensure that stakeholders' input is considered in addressing any issues that might arise under this covered agreement?

A.2. Response not received in time for publication.

Q.3. Assuming the covered agreement is implemented by both the United States and the European Union without an exchange of letters or other comfort on the interpretative questions raised by the National Association of Insurance Commissioners and others, to what extent would the United States' ability to terminate the agreement provide an effective means of mitigating risks to U.S. interests in the event that the European Union were to construe those interpretive questions against U.S. interests?

A.3. Response not received in time for publication.

RESPONSES TO WRITTEN QUESTIONS OF SENATOR CORKER FROM JULIE MIX MCPEAK

Q.1. There was some discussion during the hearing about potential opportunities to enhance the process for soliciting State insurance regulators and other stakeholders' input in connection with future Federal Insurance Office-led negotiations of covered agreements. Could you describe with some additional detail how that process should be enhanced in future negotiations?

A.1. It isn't clear that a covered agreement authority will be necessary for the future. The agreement with the EU was the product of fairly unique circumstances as the EU had something to give the United States in exchange for concessions by the United States, specifically addressing the disparate treatment that U.S. insurers were receiving by certain EU member countries under the Solvency II regime.

With that stated, if the authority is to be preserved going forward, then we would suggest the following changes. First, State insurance regulators should be included in the negotiation process and should be able to consult with their general counsels and other pertinent department staff, as well as their fellow regulators. Unfortunately, during this negotiation, only a few of us were permitted to participate and we could not share information and obtain reactions from the other States. Second, there needs to be more stakeholder involvement throughout the process and formal mechanisms for doing so, including a notice and comment period on the proposed agreement and its framework. Last but not least, Congress should have more formal mechanisms for weighing in including voting on the proposed agreement.

Q.2. How should the Joint Commission process work to ensure that stakeholders' input is considered in addressing any issues that might arise under this covered agreement?

A.2. Along with other unknowns, the nature of the committee, its responsibilities and its membership should have been clearly spelled out in the agreement itself.

Optimally, if a Joint Committee is to be convened to address interpretation issues, the process should be transparent and allow for the meaningful participation of State insurance regulators. While we would not expect all insurance regulators to be included in every meeting, there should be mechanisms by which all States can be consulted regarding the deliberations. Much of this agreement must be implemented by State insurance regulators, governors and legislators, and therefore the involvement of the States in the process to resolve disputes is critical.

Q.3. Assuming the covered agreement is implemented by both the United States and the European Union without an exchange of letters or other comfort on the interpretative questions raised by the National Association of Insurance Commissioners and others, to what extent would the United States' ability to terminate the agreement provide an effective means of mitigating risks to U.S. interests in the event that the European Union were to construe those interpretive questions against U.S. interests?

A.3. We don't think the threat of ending the agreement is an effective means of mitigating risks to U.S. interests. The key benefit to the agreement for the United States is resolving the disparate treatment that certain U.S. insurers are receiving from the EU. If we threaten to terminate the agreement, the EU will revert to their disparate treatment of our companies and the U.S. will not have achieved certainty and finality for the insurance sector. While some may argue that that the EU receives benefits such as the elimination of collateral, the U.S. stands to lose more if we wait to resolve any ambiguities through the Joint Committee. Over time, we could very well be in the position of having changed State laws in a manner that is favorable to the EU and not be able to easily or fully unwind the implementation that has already been undertaken by the States. If we terminate the agreement, the EU will preserve some of the benefits while the U.S. insurers operating in the EU could lose the main benefit U.S. negotiators obtained for them. We think the better approach is to resolve the ambiguities up front to avoid this situation and maximize the likelihood of finality and certainty for our sector.

ADDITIONAL MATERIAL SUPPLIED FOR THE RECORD

VIEWS OF THE CINCINATTI INSURANCE COMPANIES ON COVERED AGREEMENTS

VIEWS OF THE CINCINNATI INSURANCE COMPANIES ON COVERED AGREEMENTS

Statement for the Record Prepared for the Senate Banking, Housing & Urban Affairs Committee
Hearing on "Examining The U.S.-EU Covered Agreements"

[May 2, 2017]

THE U.S. SHOULD RENEGOTIATE THE PENDING COVERED AGREEMENT. The pending covered agreement should be pulled back and renegotiated since the process under which it was negotiated failed on many levels and resulted in an agreement with many procedural and substantive flaws, the terms of which could greatly damage the primacy of our state insurance regulatory system.

LACK OF TRANSPARENCY IN THE PROCESS. There was no transparency in the negotiation process. During the negotiation process there were no meaningful stakeholder process or updates for the public on the substance of what was being negotiated, and the text of the agreement was hidden from the public until it was filed with Congress on January 13, 2017.

STATE REGULATORS BARRED FROM THE NEGOTIATING TABLE. The law governing the covered agreement negotiations prohibited any meaningful participation by state regulators. State regulators were allowed to attend the negotiating sessions but were not permitted to directly or actively negotiate and were forced to sign nondisclosure agreements preventing them from revealing what they heard in those sessions. Had state regulators had real negotiating power, the outcome of the negotiation would have almost certainly been different and the terms of the covered agreement better. Instead, state regulators were put in the terrible position of being forced to watch on the sidelines as the Administration and a foreign power reshaped the landscape of state insurance regulation on reissuance collateral and group capital requirements.

THERE WAS NO NEED TO ADDRESS REINSURANCE COLLATERAL IN THE COVERED AGREEMENT. Had state regulators been allowed a meaningful role in the negotiations of the covered agreement, they would have most certainly argued against including the "zero reinsurance collateral" preemption provision in the covered agreement since the U.S. already has a state-regulated system that allows EU reinsurers to post zero collateral in the U.S. if they achieve the "Secure—1" financial strength rating under the NAIC's "sliding scale" reinsurance collateral model law. The NAIC model is well on its way to being adopted in all 50 states; 35 states have already enacted the model law and the pace for adoption by the rest of the states will now quicken since the NAIC has made enactment of the model law an accreditation requirement.[1]

THE NAIC'S "SLIDING SCALE" COLLATERAL LAW IS BETTER FOR CONSUMERS. The NAIC's "sliding scale" reinsurance collateral law is better for consumers than the provision included in the covered agreement since the NAIC model provides six different financial strength rating categories for EU reinsurers; the reinsurance collateral provision in the covered agreement only utilizes one financial strength rating for EU reinsurers. Under the NAIC sliding scale, the better the financial strength rating of the EU reinsurer, the lower the collateral requirement:

Secure—1 (0% Collateral)	Secure—4 (50% Collateral)
Secure—2 (10% Collateral)	Secure—5 (75% Collateral)
Secure—3 (20% Collateral)	Vulnerable—6 (100% Collateral)

This provides a better mechanism for U.S. insurers to judge the solvency and claims paying ability of EU reinsurers before they decide whether to do business with them, which ultimately protects consumers and policyholders who want assurance that payment of their claims will not be impacted by EU reinsurers with weak

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[1] To put the issues relating to reinsurance collateral in context, it should be noted that the states have long required EU reinsurers to post collateral for their U.S. obligations given differences in EU accounting systems, differences in the rigor of insurance regulation in the EU, and difficulty with enforcement of judgments by U.S. primary insurers against EU reinsurers in their home jurisdictions, all of which make it challenging for state regulators to rate the ability and/or willingness of EU reinsurers to pay their U.S. obligations.

financial strength ratings. The NAIC sliding scale model law also protects the U.S. guaranty fund system, which relies upon U.S. insurers to do business with reinsurers with strong financial strength ratings who will honor their U.S. obligations after a ceding company becomes insolvent.

PREEMPTIVE POWER IS UNNECESSARY TO ACHIEVE MUTUAL RECOGNITION. The covered agreement creates a process for state reinsurance collateral laws to be preempted if they are not revised to comply with the terms of the covered agreement. Allowing a covered agreement to preempt state laws puts the power of dictating U.S. regulatory policy in the hands of non-regulatory federal bodies and foreign governments. The U.S. should continue to pursue mutual recognition agreements with foreign bodies which recognize the robustness of our state regulatory system and put U.S. companies on a level playing field, but they should not overwrite state laws or otherwise sacrifice state insurance regulation to achieve those objectives. As such, covered agreements should have no preemptive power and should be limited to securing mutual recognition of the U.S. system under the EU's Solvency II regulatory regime.

OTHER SUBSTANTIVE FLAWS IN THE COVERED AGREEMENT. The covered agreement has three additional substantive flaws that might have been avoided if state regulators had a voice in the process and a seat at the negotiating table:

- The covered agreement fails to grant the U.S. regulatory system full equivalency under the EU's Solvency II regulatory regime. As a result, U.S. domiciled insurers will not be permitted to operate in the EU on the same regulatory terms as insurers domiciled in the EU.
- The covered agreement requires the states to enact a group capital requirement, contrary to the desires of the NAIC (the NAIC is in the process of developing a group capital calculation which they do not want to become to become a capital requirement).
- The covered agreement creates a "Joint Committee" with considerable authority to implement the covered agreement in the U.S., but its members will not include anyone representing state insurance regulatory authorities.

NO MEANINGFUL CHECK & BALANCE BY CONGRESS. The law which governs the covered agreement negotiation process is also flawed by the absence of any meaningful check and balance by Congress. Under the current process, the Administration can unilaterally preempt state insurance laws through a covered agreement. The only Congressional check on this power is a 90 day layover requirement (a covered agreement may not be implemented until 90 days after it is filed with Congress). In contrast, the EU requires two legislative approvals before implementation. Congress needs to have check and balance power over covered agreements which is as meaningful as the EU's check and balance power over them.

CONCLUSION: RENEGOTIATE THE FLAWED COVERED AGREEMENT. The current law under which covered agreements are negotiated needs to be reformed by Congress to address the deficiencies identified above. Once that occurs, the Administration should return to the negotiating table with state insurance regulators, and, with the benefit of an open and transparent process and meaningful checks and balances, seek a covered agreement which grants mutual recognition and Solvency II equivalence to U.S. insurers doing business in the EU.

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