

## US/EU Covered Agreement Talks Begin Solvency II Looms January 1, 2016

On January 1, 2016, the European Union (EU) will implement insurance regulatory reforms, known as “Solvency II”, which will negatively impact a non-EU insurer doing business in the EU if that insurer’s regulator is not deemed “equivalent” under the provisions of Solvency II. Without a determination of equivalence or a covered agreement, the Solvency II rules, which are stricter than U.S. rules, could apply to a U.S.-based insurer’s or reinsurer’s subsidiaries operating in the EU. The Secretary of the U.S. Department of the Treasury (Treasury), working through the Federal Insurance Office (FIO), and the Office of the United States Trade Representative (USTR) are jointly authorized pursuant to the Dodd-Frank Wall Street Reform and Consumer Protection Act to negotiate a covered agreement with one or more foreign governments, authorities, or regulatory entities to recognize certain prudential measures with respect to the business of insurance or reinsurance that achieve a level of protection for consumers that is substantially equivalent to the level of protection achieved under State insurance or reinsurance regulations. Treasury publicly called for a covered agreement in FIO’s 2013 Report, “How to Modernize and Improve the System of Insurance Regulation in the United States,” and has now announced that, together with the USTR, it will seek recognition of certain areas of State insurance regulation to create “equivalence” for U.S. insurers and reinsurers doing business in Europe. In addition, they will seek nationally uniform treatment of EU-based reinsurers operating in the U.S., including with respect to collateral requirements. U.S. (re)insurers with operations in the EU are concerned that without equivalence under Solvency II they will be at a competitive disadvantage.

**Current status:** Solvency II is an EU Directive that codifies and harmonizes EU insurance regulation. Solvency II includes provisions for equivalence assessments of jurisdictions outside the EU (termed “third countries”). There are three areas of Solvency II equivalence: the solvency calculation, group supervision, and reinsurance. The U.S. insurance regulatory system has been determined provisionally equivalent for a period of ten years beginning January 1, 2016, though only for the solvency calculation. Group supervision and reinsurance are equivalence issues that remain unresolved and the subjects of covered agreement talks. U.S. insurers could face possible retaliation from restrictions or charges on U.S. companies doing business in the EU under Solvency II without equivalence in these areas. In November 2015, the Treasury and the USTR notified Congress they were formally initiating negotiations on a covered agreement with the EU. When completed, it is contemplated the covered agreement will establish criteria for group supervision, reinsurance, and the confidential exchange of information. No time line has been established for the negotiations.

**In summary:** A covered agreement has the ability to pre-empt State law and the National Association of Insurance Commissioners (NAIC) has been concerned that this would pre-empt the significant progress on reinsurance issues in the U.S. A number of states have made efforts to stall or stop the covered agreement talks by adopting the amended 2011 NAIC Model Law on Credit for Reinsurance, which shows the U.S. is willing to work together for mutual recognition. However, adoption of the Model Law is ongoing. Currently, 32 states have adopted Model Law legislation comprising 66 percent of direct insurance premium written in the U.S. An additional five states have taken up the legislative process, which, if adopted by all of these five states, would bring the direct insurance premium coverage to 93 percent. There are still likely differences between the states regarding implementation and adoption is not uniform.

State regulators had hoped that adding collateral reform as an accreditation factor would demonstrate that the NAIC is addressing the issue and that a covered agreement would be unnecessary.

In the interest of uniformity, the NAIC Accreditation (F) Committee supports the uniform adoption of the Credit for Reinsurance Model Law as an accreditation requirement and to forestall the need for a covered agreement or action at the U.S. Federal level. The NAIC is making efforts to speed the process of adoption by all states, including the optionality to accelerate the seasoning of an accreditation requirement. The U.S. State regulators pointed out they feel that the certified reinsurer determination is more effective than 100 percent collateral in that the financial performance of a reinsurer is evaluated as opposed to only a collateral requirement regardless of financial strength.

**Possible implications:** Without Solvency II equivalence, U.S. insurers and reinsurers with operations in the EU will likely be negatively impacted if an agreement cannot be reached prior to year-end. Important points to consider:

- U.S. insurers operating in the EU may be subject to duplication of group supervision requirements and other regulatory burdens under Solvency II, including the posting of collateral for EU reinsurance business making it more difficult for U.S. insurers to operate in the European markets.
- The EU could impose their standards without consideration of U.S. State regulatory requirements, which may include additional regulatory retaliatory initiatives.
- The uncertainty created by the lack of equivalence is a distraction and concern for U.S. based insurers.
- The covered agreement process is a significant step toward furthering the Federal government's role in insurance regulation.

Note that the U.S. equivalence determination in effect for the solvency calculation benefits the EU insurers operating in the U.S. Without the equivalence designation, a U.S. subsidiary of an EU parent would likely be negatively impacted relative to U.S. counterparts since Solvency II requirements are likely to be higher and they would be required to comply with Solvency II calculations.

With the January 1, 2016, effective date for Solvency II rapidly approaching, a covered agreement and "equivalence" will remain on top of the agenda for U.S.-based insurers and reinsurers. The issue was discussed at length at the NAIC meeting and followed up at the EU/US Insurance Project held immediately afterwards. Answers as to where the covered agreement question and the influence of Solvency II on the U.S. insurance industry will be in 2016 remain pending. The group supervision and reinsurance collateral discussions will have to consider where the covered agreement requirements coordinate with State regulatory authorities and initiatives. Possibilities do exist for provisional equivalence similar to the solvency determination or a sort of forbearance, wherein the U.S. and EU agree to mutual recognition of the two regulatory systems while considering the different insurance markets. Considering that the EU and the U.S. are the largest insurance markets in the world, there is high incentive to come to a mutual recognition of each jurisdictions regulatory systems and support open insurance markets.

**For additional information, please contact:****Amy Matsuo****Principal and National Lead**

Financial Services Regulatory Risk Practice

**T:** 919-380-1509**E:** amatsuo@kpmg.com**Ken Albertazzi****Partner**

Financial Services Regulatory Risk

Safety &amp; Soundness

**T:** 212-954-4904**E:** kalbertazzi@kpmg.com**Stacey Guardino****Partner**

Financial Services Regulatory Risk

Enterprise-Wide and Consumer Compliance

**T:** 212-954-4950**E:** sguardino@kpmg.com**Bob Kasinow****Director**

Financial Service Regulatory Risk

Safety &amp; Soundness

**T:** 973-912-4534**E:** rkasinow@kpmg.com

The Americas Financial Services Regulatory CoE is based in Washington, DC and comprised of key industry practitioners and regulatory advisers from across KPMG's global network.



SOME OR ALL OF THE SERVICES DESCRIBED HEREIN MAY NOT BE PERMISSIBLE FOR KPMG AUDIT CLIENTS AND THEIR AFFILIATES.

ALL INFORMATION PROVIDED HERE IS OF A GENERAL NATURE AND IS NOT INTENDED TO ADDRESS THE CIRCUMSTANCES OF ANY PARTICULAR INDIVIDUAL OR ENTITY. ALTHOUGH WE ENDEAVOR TO PROVIDE ACCURATE AND TIMELY INFORMATION, THERE CAN BE NO GUARANTEE THAT SUCH INFORMATION IS ACCURATE AS OF THE DATE IT IS RECEIVED OR THAT IT WILL CONTINUE TO BE ACCURATE IN THE FUTURE. NO ONE SHOULD ACT UPON SUCH INFORMATION WITHOUT APPROPRIATE PROFESSIONAL ADVICE AFTER A THOROUGH EXAMINATION OF THE FACTS OF THE PARTICULAR SITUATION.