WILLKIE FARR & GALLAGHER LLP

CLIENT MEMORANDUM

# NAIC REPORT: 2013 SPRING NATIONAL MEETING

The 2013 Spring National Meeting ("Spring National Meeting") of the National Association of Insurance Commissioners ("NAIC") was held in Houston, Texas from April 6 – 9, 2013. This meeting marks the first national meeting for former U.S. Senator Ben Nelson, who is the NAIC's new Chief Executive Officer.

The NAIC's Solvency Modernization Initiative ("SMI") began in June 2008 and remains a significant initiative involving many NAIC committees, working groups and task forces. Today, SMI standards have been implemented through amendments to the Model Holding Company Act and Regulations, amendments to the Credit for Reinsurance Model Law and Regulations and the recently adopted Risk Management and Own Risk and Solvency Assessment Model Act. In addition, principles-based reserving implementation continues to dominate discussions. The Spring National Meeting was also host to the inaugural meeting of the newly formed Financial Stability (EX) Task Force, which is charged with, among other things, considering the role of state insurance regulators in U.S. and global regulation of financial stability, and will serve as the forum for regulators to coordinate their views with regard to "systemically significant" insurer designations.

The report below summarizes some of the activities at the Spring National Meeting that may be of interest to our clients in the insurance industry.

## I. Topics of General Interest to the Insurance Industry

### A. Group Solvency and Group Supervision

At the Spring National Meeting, the Group Solvency Issues (E) Working Group ("GSIWG") exposed two documents for comment: (i) "Roles and Responsibilities of U.S. Lead State/U.S. Group-Wide Supervisor Document" ("GSIWG Exposure Draft") and (ii) proposed revisions to the *Financial Analysis Handbook*'s Financial Analysis Review Team Guidelines Regarding Holding Company Analysis.

#### 1. Group Supervision and the Role of the Lead State Insurance Regulator

The goals of the GSIWG Exposure Draft are to (a) codify in a single document for the benefit of U.S. insurance regulators the U.S. approach to group supervision and (b) educate international regulators regarding the U.S. approach as it compares to other international group supervision standards. If adopted, the GSIWG Exposure Draft would constitute a new document to be included in the *Financial Analysis Handbook*.

The GSIWG Exposure Draft describes the legal foundation for U.S. regulators' authority to exercise group-wide supervision and, importantly, emphasizes that although a U.S. lead state regulator must understand all the risks posed by regulated and unregulated entities within the group, the lead state regulator does not have legal authority over other regulated entities within the group and is not authorized to usurp the authority of another regulator or another jurisdiction. In this regard, the GSIWG Exposure Draft defines "group-wide supervision" as monitoring the group's financial condition, determining whether additional information is appropriate and "determining through a coordinated process with other functional regulators, the extent to which additional action is appropriate."

The U.S. lead state regulator system for the coordination and development of group information affecting U.S. domestic insurers is described in detail, and the GSIWG Exposure Draft enumerates a number of responsibilities for the lead state, including: (a) completion of the holding company analysis, (b) assessment of corporate governance risks, (c) assessment of enterprise risk management risks, (d) coordinating meetings with other regulators of the insurance group, (e) determining whether targeted examination procedures are required and (f) considering whether a Supervisory College should be held. Although a number of these responsibilities are discussed in greater depth throughout the GSIWG Exposure Draft, some of them, including the assessment of corporate governance risks, will be developed in conjunction with other NAIC committees and working groups. Furthermore, the GSIWG Exposure Draft envisions that an insurance holding company system's lead state regulator will maintain a Group Profile Summary that will include the summaries of the group's "risk-focused examinations, financial analysis, internal and external changes, priority scores, supervisory plans, and other group information." The comment period for the GSIWG Exposure Draft ends on June 7, 2013.

### a. The Lead State Regulator's Role in Completion of Holding Company Analysis

The GSIWG also proposed changes to the *Financial Examiners Handbook* with respect to review team guidelines for holding company analysis and recommended that the Financial Regulation and Accreditation (F) Committee adopt such changes prior to January 1, 2014.

The proposed changes are derived from state regulators' experiences in completing domestic insurers' holding company system analyses and relate to the expectations for lead state regulators and other domestic state regulators pertaining to the holding company analysis, including the lead state regulator's communication of results to other state regulators.

The proposed changes include guidelines for the analysis performed by a lead state regulator including the lead state regulator's reliance on work performed by an international insurance supervisor or another functional regulator in developing the lead state regulator's holding company system analysis. The non-lead state regulator's reliance on the lead state regulator's analysis and documentation of the impact on a domestic insurer is also addressed in the proposed review team guidelines.

**2. Amendments to the Model Insurance Holding Company Act and Regulations**

During the 2013 legislative sessions, various states have introduced the amendments to the Model Insurance Holding Company Act ("Amended HCA") that were adopted by the NAIC in 2010. Thus far this year, several states have adopted legislation substantially incorporating the Amended HCA, including Idaho, Kansas, Maryland, Mississippi and Wyoming. This brings the total number of jurisdictions that have adopted the Amended HCA to 16, (i.e., California, Connecticut, Idaho, Indiana, Kansas, Kentucky, Louisiana, Maryland, Mississippi, Nebraska, Pennsylvania, Puerto Rico, Rhode Island, Texas, West Virginia and Wyoming), with four having also adopted amended regulations (i.e., Nebraska, Rhode Island, Texas and West Virginia).

New York has promulgated a regulation that incorporates some aspects of the Amended HCA, which will become effective on June 23, 2013. The New York regulation incorporates the concept of directors and management overseeing or monitoring corporate governance practices and internal controls, the addition of certain types of affiliate transactions to those requiring approval under Section 1505 of the New York Insurance Law ("NYIL"), and a requirement to file notice prior to the divestiture of controlling interests in a New York insurer. New York has also introduced legislation that incorporates other aspects of the Amended HCA, including the Superintendent's authorization to participate in supervisory colleges and changes to some of the thresholds in Section 1505 of the NYIL. However, neither the promulgated regulation nor the proposed legislation incorporates an enterprise risk report requirement as of this time. At the time that the regulation was proposed, accompanying filing materials indicated that the New York Department of Financial Services ("NYDFS") intended to introduce legislation requiring an enterprise risk report that would apply not only to the New York Holding Company Act, but also companies regulated by Articles 16 and 17 of the NYIL (i.e., subsidiaries of New York insurers). Such legislation has not yet been introduced.

One of the more dramatic moments of the Spring National Meeting came in the Financial Regulation Standards and Accreditation (F) Committee meeting, where the National Association of Mutual Insurance Companies ("NAMIC") proposed revisions to the Amended HCA granting states discretion to exempt an insurer from the enterprise risk report requirement if the insurer has less than $500 million in direct written premium. NAMIC's suggestion was roundly denounced by committee members, with Deputy Insurance Commissioner Steve Johnson of Pennsylvania and Superintendent Joseph Torti of Rhode Island being particularly vocal in pointing out that such an exemption was considered and rejected during the formulation of the Amended HCA. Further, Mr. Johnson questioned whether states whose laws include an exemption for smaller companies (e.g., Texas and Kansas) will satisfy the accreditation standards. No action was taken on NAMIC's request, and Mr. Johnson indicated that the issue will be raised again at the 2013 Summer National Meeting. The Committee continues to consider which "significant elements" of the Amended HCA and amended regulations should be included in the accreditation standards, but no formal action was taken.

### 3. Update Regarding Own Risk and Solvency Assessment ("ORSA")

After initially adopting the Own Risk and Solvency Assessment Guidance Manual ("ORSA Guidance Manual") in the spring of 2012, the NAIC adopted the Risk Management and Own Risk and Solvency Assessment Model Act ("ORSA Model Act") in September 2012. Since then, the NAIC has continued to update and refine its guidance with respect to conducting an ORSA. At the Spring National Meeting, the GSIWG finalized its proposal to make adoption of the ORSA Model Act an accreditation standard. This proposal was released by the Financial Regulation Standards and Accreditation (F) Committee for a 30-day comment period.

In the seven months since the NAIC adopted the ORSA Model Act, legislation has been introduced in the following eight states: California, Connecticut, Iowa, New Hampshire, Rhode Island, Texas, Vermont and Virginia. The ORSA legislation was subsequently withdrawn from consideration by the Virginia legislature by its sponsor at the request of the Virginia insurance regulator, in order to refine the language originally proposed. Recently, the Iowa state legislature passed ORSA legislation that is currently awaiting signature by the Iowa Governor. If signed, Iowa would be the first state to enact the ORSA Model Act.

### 4. SMI Update

The SMI White Paper aims to explain the U.S. solvency regulatory framework, including its functions and the reasons for its success, while detailing the strengths of the U.S.'s reliance on a state-based system of regulation. The NAIC first drafted a white paper on these topics in 2010. The SMI White Paper serves as an update to the NAIC's 2010 white paper and continues the NAIC's efforts to explain the U.S. insurance regulatory system to others, including international bodies.

At the Spring National Meeting, the Solvency Modernization Initiative (E) Task Force ("SMI Task Force") released the SMI White Paper for a final 60-day period that will end on June 6, 2013. It is expected that the SMI White Paper will be presented for adoption at the 2013 Summer National Meeting.

The SMI Task Force also announced at the Spring National Meeting that it will begin working on an "SMI Dashboard" to track state adoption of SMI related model laws nationwide (e.g., the Amended HCA, amendments to the NAIC's Credit for Reinsurance Model Law and Regulations, the recently adopted ORSA Model Act, and principles-based reserving implementation). This SMI Dashboard is slated to be made available by the 2013 Summer National Meeting.

## B. Financial Stability (EX) Task Force Debuts

The first meeting of the new Financial Stability (EX) Task Force ("Financial Stability Task Force") was held during the Spring National Meeting. The charges of the Financial Stability Task Force include considering the role of state insurance regulators in U.S. and global regulation of financial stability, working together in developing roles in national and international discussions regarding macro-financial vulnerabilities, and serving as the forum for

regulators to coordinate their views with regard to "systemically significant" insurer designations. Commissioner Leonardi of Connecticut opened the meeting by stating that the Financial Stability Task Force would take a holistic approach to its charges, and that it would not be trying to reinvent the wheel. He expressed concern about the possibility of the perception of a two-tiered system within the industry: those companies designated as global systemically important financial institutions ("G-SIFIs") and those that are not, and the possible positive and negative outcomes of such a perception.

The Financial Stability Task Force indicated that its priorities include assisting with the prompt adoption of SMI legislation (e.g., the Amended HCA, ORSA), streamlining group supervision through promoting the use of supervisory colleges, pushing to obtain a multilateral memorandum of understanding signed by all states, and avoiding future crises in the insurance industry. As an executive (EX) level task force, it is authorized to make recommendations to and prepare comment letters for the NAIC's International Insurance Relations (G) Committee, Government Relations (EX) Leadership Council and the International Insurance Relations (EX) Leadership Group.

### C. Corporate Governance

The Corporate Governance (E) Working Group ("CGWG") was formed in 2009 in part to address the results of the 2009 assessment of the U.S. insurance regulatory system by the Financial Sector Assessment Program ("FSAP") of the United States.[1] It was originally charged with developing high-level principles to be used for corporate governance oversight. The CGWG produced a white paper on corporate governance, but the white paper was not adopted by the NAIC.

As a result of the lukewarm industry reaction to its first white paper, the CGWG shifted focus and began to study and summarize existing corporate governance requirements for U.S. insurers. The CGWG's summary, which was adopted in December 2011, identified seven core principles of the U.S. insurance financial solvency framework. Upon completion of the summary, the CGWG determined that a model law on corporate governance was neither necessary nor appropriate. Instead, in 2012, it began to undertake a comparative analysis of U.S. corporate governance standards against international standards, including the Insurance Core Principles ("ICPs"). The CGWG found that, in a number of instances, it was not advisable to require changes to U.S. corporate governance regulation solely to conform to the ICPs.

Ultimately, the CGWG drafted a new document entitled "Proposed Responses to a Comparative Analysis of Existing U.S. Corporate Governance Requirements" ("CGWG Proposal"). Initially released for comment in August 2012, certain portions of the CGWG Proposal were re-released in November 2012. Following incorporation of input from industry and regulators, the CGWG Proposal sets forth a number of proposals for corporate governance enhancements, including:

---

[1] The International Monetary Fund regularly conducts FSAP reviews of participating countries' financial sectors, including the quality of insurance supervision. The United States undergoes an FSAP review every five years.

i. requiring regular filing of confidential information regarding an insurer's corporate governance with its domestic regulator through the development of a new model law ("Exhibit A");

ii. amending the Annual Financial Reporting Model Regulation, commonly referred to as the Model Audit Rule, to require insurers above a size threshold to maintain an internal audit function;

iii. including additional data with respect to executive and director compensation in an insurer's Supplemental Compensation Exhibit to its Annual Statement;

iv. requesting that the Financial Analysis Handbook (E) Working Group clarify its procedures for reviewing the suitability of insurers' directors and officers; and

v. sending referrals to certain technical and working groups for guidance on the incorporation of corporate governance-related ICPs into the financial examination process.

The CGWG Proposal was adopted by the CGWG, the SMI Task Force, and the Financial Condition (E) Committee at the Spring National Meeting. The CGWG Proposal contains a number of referrals to other NAIC committees, which have been sent out. It is expected that the CGWG will monitor responses to these referrals through future conference calls.

The CGWG would implement its first proposal through the so-called "Exhibit A," a proposed annual filing that would seek to improve risk-focused oversight by obtaining corporate governance information from insurers more frequently than once every exam cycle. Although it was originally envisioned as a part of an insurer's Annual Statement, Exhibit A has evolved into a stand-alone filing, the confidentiality of which will be protected through the adoption of a stand-alone model law. It has not yet been determined whether Exhibit A will itself be a part of the model law or whether it will exist outside of the model law and be incorporated by reference therein, in a manner similar to the framework of the ORSA Guidance Manual and the ORSA Model Act. The Request for Model Law Development of the "Annual Reporting of Corporate Governance Practices of Insurers Model Act" was approved at the Spring National Meeting by the CGWG, the SMI Task Force and the Financial Condition (E) Committee.

In order to implement the CGWG's second proposal, the CGWG, the SMI Task Force and the Financial Condition (E) Committee also adopted a Request for Model Law Development that would allow for amendments to the Model Audit Rule. The CGWG's proposed amendments were recommended by the 2009 FSAP review and by last year's EU/US Dialogue; if adopted, the amendments would incorporate an additional ICP into the U.S. system of insurance regulation while also addressing certain gaps in the Model Audit Rule's requirements. The Model Audit Rule currently requires insurers with more than $500 million in annual premiums to file a Management's Report of Internal Control over Financial Reporting that must include a statement regarding the insurer's internal control systems. However, the Model Audit Rule does not actually require such insurers to maintain an effective internal audit function that the insurer

can rely upon to complete its financial reporting. Thus, the CGWG proposes to amend the Model Audit Rule to require insurers with more than $500 million in annual premiums to maintain an effective internal audit function. Specifically, in order for an insurer's internal audit function to be "effective," it will need to be capable of independently assuring the Audit Committee with respect to the insurer's governance, risk management and internal controls. The CGWG will also consider international guidance when enumerating more explicit standards for the internal audit function including, perhaps, a requirement that the internal audit function be capable of investigating financial reporting and IT systems.

The NAIC's Executive Committee and Plenary will need to approve both of the CGWG's Requests for Model Law Development. Once this approval is received, the CGWG will begin working on both requests. Because the CGWG cannot work on either request until the NAIC charges it to do so, the CGWG asked interested parties to begin thinking about the Request for Model Law Development relating to the stand-alone model law; this approach is similar to the path that led to the development of the ORSA Model Act.

### D. The NAIC's Amended Credit for Reinsurance Model Law

#### 1. Update Regarding Implementation of the Amended Credit for Reinsurance Model Act

The Reinsurance (E) Task Force reported at the Spring National Meeting that 11 states have adopted revisions to their credit for reinsurance statutes and/or regulations to implement reduced collateral requirements contained in the NAIC's amendments to its Credit for Reinsurance Model Law and Regulations ("Amended Credit for Reinsurance Model Act"), which is unchanged from the Reinsurance Task Force's report at the 2012 Fall National Meeting. These states are: California, Connecticut, Delaware, Florida, Georgia, Indiana, Louisiana, New Jersey, New York, Pennsylvania and Virginia. A further 12 states have indicated that they intend to adopt the revisions. It was again reported that only Florida and New York have approved any reinsurers for collateral reduction.

#### 2. Drafting Group Update – "Qualified Jurisdictions"

The Amended Credit for Reinsurance Model Act provides that, in order to be eligible for certification and collateral reduction, a reinsurer must be domiciled and licensed to transact insurance or reinsurance in a "qualified jurisdiction." State insurance commissioners are responsible for determining whether the reinsurer's domiciliary jurisdiction is eligible to be recognized as a qualified jurisdiction, and the Amended Credit for Reinsurance Model Act requires state insurance commissioners to consider the NAIC's list in making this determination.[2]

[2] If a state insurance commissioner approves as qualified a jurisdiction that does not appear on the NAIC's list of qualified jurisdictions, the commissioner is then required to provide thoroughly documented justification with respect to the applicable criteria as set forth in the Credit for Reinsurance Model Act.

The NAIC's process for reviewing non-U.S. jurisdictions in this regard is set forth in a draft document entitled "NAIC Process for Developing and Maintaining a List of Qualified Jurisdictions" ("Process"). The initial draft of the Process was exposed on November 28, 2012 for a 45-day comment period and, following receipt of comments from the industry/interested parties, a revised draft was exposed for a further 30-day comment period at the Spring National Meeting. Notable among the changes to the Process in its current form is the ability to designate "Conditional Qualified Jurisdiction" status for those jurisdictions that will undergo an "expedited" review. The jurisdictions slated for an expedited review are those which were approved by Florida and New York prior to the NAIC's adoption of the Amended Credit for Reinsurance Model Act (i.e., Bermuda, Germany, Switzerland and the United Kingdom). This more expeditious review is attributed to U.S. state insurance regulators' familiarity with these particular jurisdictions, and will facilitate the certification of reinsurers domiciled therein. Under the expedited review process, Section A (Laws and Regulations) and Section B (Regulatory Practices and Procedures) of the "evaluation methodology" utilized in the Process will be initially deferred. Final qualification of each "Conditional Qualified Jurisdiction" would be contingent upon completion of a full evaluation procedure. The current draft of the Process further provides that a jurisdiction may maintain the "Conditional Qualified Jurisdiction" status for no more than one year.

In addition, the Process has eliminated the requirement that applicant jurisdictions provide a self-evaluation report. Instead, the NAIC will use a jurisdiction's most recent FSAP report and other publicly available information regarding the laws, regulations, practices and procedures applicable to the reinsurance supervisory system. The Process now also provides for on-site evaluations at the discretion of the NAIC, rather than as a required aspect of the evaluation process.

The expedited review, reliance on existing information and optional, rather than mandatory, on-site evaluation are all intended to streamline the Process and reduce associated costs in response to several interested parties' comments that the Process had been too burdensome. Indeed, commenters noted concern that by imposing an overly burdensome evaluation process on non-U.S. jurisdictions, U.S. states themselves could in turn be subjected to a similar review by foreign jurisdictions using the Process as a model for such a review.

During the Reinsurance Task Force's meeting in Houston, those who had commented on the initial draft of the Process expressed general satisfaction with the fact that the revised draft Process sought to address many of the issues raised during the first comment period. While further revisions are likely, the Reinsurance Task Force appears to be on track to have the Process finalized soon for consideration by the Financial Condition (E) Committee, with initial conditional approvals commencing by year-end. This marks an impressive timeline given that that the Amended Credit for Reinsurance Model Act was adopted by the NAIC little over a year ago.

### 3. Reinsurance Financial Analysis Working Group Update

The Reinsurance (E) Financial Analysis Working Group ("Reinsurance-FAWG"), which was established to provide advisory support and assistance to states in the review of reinsurance collateral reduction applications, is a confidential, regulator-to-regulator only group. Although the Reinsurance-FAWG will not have the authority to assign ratings or collateral requirements for reinsurers (that authority is reserved to the states), the industry has been critical of the lack of disclosure surrounding this group's processes. In response, Pennsylvania Deputy Insurance Commissioner Steve Johnson, who serves as the chair of the Reinsurance-FAWG, provided an informational memorandum outlining the group's (i) mission and charges, (ii) procedures, (iii) ongoing monitoring process and (iv) confidential treatment of all matters discussed in its meetings and correspondences.

Mr. Johnson noted at the Spring National Meeting that the Reinsurance-FAWG is up and running, and has reached out to New York and Florida (i.e., the only states that have approved any reinsurers for collateral reduction), requesting that they submit information with respect to the companies they have reviewed so that the Reinsurance-FAWG can begin its work assessing those companies and sharing their findings with other NAIC member jurisdictions.

### 4. FIO Requests NAIC to Conduct Survey on Access to Reinsurance Information

It was noted during the Reinsurance Task Force's meeting that the Federal Insurance Office ("FIO") had recently requested that the NAIC conduct a survey of its member jurisdictions as to the impact of Part II (Reinsurance) of the Nonadmitted and Reinsurance Reform Act on the ability of state insurance regulators to access reinsurance information for regulated companies in their jurisdictions. The Dodd-Frank Wall Street Reform and Consumer Protection Act requires the FIO director to submit a report on this very subject by January 1, 2013. This report is still pending, although FIO Director Mike McRaith indicated in a recent meeting of FIO's advisory board, the Federal Advisory Committee on Insurance ("FACI"), that some or all of FIO's outstanding reports would be released by July 2013.

## II. Topics of Interest to the Life Insurance Industry

### A. Principles-Based Reserving Implementation Moves Forward

Principles-Based Reserving ("PBR") is intended to replace the current formulaic approach to determining life insurance policy reserves with an approach aimed at better aligning policy reserves to product risks. As previously reported, PBR is comprised of three principal components: (i) the Model Standard Valuation Law, which was revised by the NAIC in 2009[3], (ii) the Standard Nonforfeiture Law for Life Insurance, which was amended by the NAIC in August 2012 and (iii) a Valuation Manual, which was narrowly adopted by a supermajority of NAIC members in December 2012.

---

[3] The Financial Regulation Standards and Accreditation (F) Committee opted during the Spring National Meeting to delay voting on the revisions to the Model Standard Valuation Law as an update to the accreditation standards pending implementation of PBR.

When the Valuation Manual was adopted, the NAIC also voted to elevate the former Principles-Based Reserving (E) Working Group to an executive level joint working group of the Life Insurance and Annuities (A) Committee and Financial Condition (E) Committee. This group, which is now known as the Principles-Based Reserving Implementation (EX) Task Force ("PBR Task Force"), serves as the coordinating body with NAIC technical groups involved with projects related to the PBR initiative for life and health policies (e.g., Life Actuarial (A) Task Force), and will further assess the solvency implications of life insurer-owned captive insurers and alternative mechanisms.

The PBR Task Force met at the Spring National Meeting and presented for discussion a revised draft of the PBR implementation plan ("Implementation Plan"), which had been exposed for comment at the 2012 Fall National Meeting. The Implementation Plan, which was exposed again at the Spring National Meeting for a 30-day comment period (to end on May 6, 2013), sets forth certain proposals designed to assist in implementing PBR, including training and additional resources for regulators. The Implementation Plan will serve as an important roadmap and tool for state insurance regulators, and seeks to address concerns raised by certain regulators that insurance departments currently lack sufficient resources and expertise to effectively implement PBR.

Notably, the revised Implementation Plan now references the fact that the solvency implications of life insurer-owned captive insurers and other alternative mechanisms will need to be assessed in the context of PBR. The Implementation Plan draws no conclusions in this regard, and instead acknowledges that the "solution for captives and SPVs within the context of PBR will be largely based on the Captives and Special Purpose Vehicle Use (E) Subgroup's report…."

In addition to exposing the Implementation Plan for comment at the Spring National Meeting, the PBR Task Force exposed a draft legislative brief and PBR "Questions and Answers" sheet ("Legislative Packet") for a 30-day comment period (to end on May 6, 2013). The Legislative Packet is intended to assist state insurance regulators as they work with their legislators to amend their respective Standard Valuation Law. New York, which had voted against adoption of the Valuation Manual at the 2012 Fall National Meeting, abstained from voting to expose the Legislative Packet for comment. The PBR Task Force plans to hold a conference call on May 13, 2013 to discuss comments received to the Implementation Plan and the Legislative Packet.

Upon legislative adoption of the amended Model Standard Valuation Law by a supermajority of jurisdictions (42) representing at least 75% of the applicable U.S. premium, the Standard Valuation Law and the Valuation Manual will become effective and PBR will become operative. This requirement all but guarantees that larger states such as New York and California, which had voted against and abstained from voting, respectively, on adoption of the Valuation Manual at the 2012 Fall National Meeting, will hold considerable influence over PBR implementation. Nonetheless, it was reported at the PBR Task Force meeting that PBR legislation has already been introduced in nine states, with one additional state having the legislation drafted and ready to be introduced.

## B. Use of Captives and Special Purpose Vehicles ("SPVs")

### 1. The Captive/SPV White Paper

On March 14, 2013, the Captive and SPV Use Subgroup ("Captive/SPV Subgroup") of the Financial Condition (E) Committee released a revised draft of its Captive and Special Purpose Vehicles White Paper ("Captive White Paper") for a 45-day comment period. The date set for final submission of comments ended on Monday, April 22, 2013. Given that the Draft White Paper was still out for comments, the Captive/SPV Subgroup did not meet during the Spring National Meeting.

As previously reported, the formation of the Captive/SPV Subgroup was prompted in part by regulators' concerns regarding consistent requirements among U.S. jurisdictions' regulation of insurance company-owned captives and SPVs. The Captive/SPV Subgroup's focus and concerns do not relate to the traditional self-insurance captive structure, but rather to the use of captives and SPVs by life insurance companies or insurance company holding companies to transfer insurance risks. Accordingly, the Captive/SPV Subgroup is studying and preparing the Captive White Paper regarding whether the existing regulatory framework for captives is appropriate for regulating an insurance company-owned captive or SPV. While the Captive White Paper will not itself implement any changes, the recommendations of the Captive/SPV Subgroup, if accepted, could ultimately lead to further studies and charges by the applicable NAIC committees, task forces, working groups and/or subgroups.

The Captive/SPV Subgroup recommendations set forth in the current draft of the Captive White Paper for consideration and/or possible further study include the following:

#### a. Accounting Considerations

The Captive/SPV Subgroup recommends that a separate subgroup be formed to address any remaining XXX and AXXX perceived redundancies following changes made to Actuarial Guideline 38 in 2012, and assess the impact of PBR on commercial insurers' need to create new captives and SPVs. Superintendent Joseph Torti of Rhode Island, who co-chairs the PBR Task Force, said that while PBR may reduce the use of life insurer-owned captive insurers and SPVs to deal with perceived XXX and AXXX reserve redundancies, it is not a foregone conclusion that PBR will necessarily eliminate their use, noting that there are those in the life insurance industry who still view PBR as too conservative and thus, even with PBR, captives and other alternative mechanisms may continue to be used. Superintendent Torti indicated that the ultimate goal of PBR is to reach agreement among regulators and the industry on appropriate reserving.

#### b. Confidentiality

The Captive/SPV Subgroup was unable to reach a consensus on the issue of confidentiality related to insurer-owned captives and SPVs and is therefore recommending that the NAIC study the issue in order to better understand the specific reasons for and against the use of

confidentiality for such entities. Currently, based on the Captive/SPV Subgroup's study, publicly available information is generally very limited, and filings made by captives and SPVs are considered confidential. The Captive/SPV Subgroup did agree that a higher level of confidentiality is appropriate for "pure" captive insurers as they do not issue insurance policies to the public, but concluded only that the level of confidentiality afforded to captives that assume insurance risk from commercial insurers requires further study. Those in support of confidentiality highlighted the concern that many commercial insurers utilize captives/SPVs for single transactions, and therefore requiring that financial information be made publicly available would enable competitors to learn the otherwise confidential economic aspects of a given transaction, potentially in violation of non-disclosure agreements in place with respect to the transaction. Those in favor of increased transparency noted that the majority of information that would be required is similar to information that commercial insurers are required to disclose with respect to other transactions and, thus, granting confidential treatment for transactions involving captives/SPVs may not be justifiable.

#### c. Access to Alternative Markets

The Captive/SPV Subgroup recommends that the NAIC re-evaluate the Special Purpose Reinsurance Vehicle Model Act (Model 789), and consider updating it to reflect alternative market solutions designed to shift risk to the capital markets or provide other forms of business financing that would be acceptable to state insurance regulator, the objective being to ensure uniformity in this area. To that end, the Captive/SPV Subgroup further suggests that the NAIC consider making this model act an accreditation standard. Currently, only four states have adopted this model act, which is limited in scope to special purpose reinsurance vehicles whose business consists exclusively of reinsurance contracts that are tied to the risk of specific triggering events and that are financed by securitizations.

#### d. Credit for Reinsurance Model Act Enhancements

With respect to Captive/SPV transactions that involve conditional letters of credit or other forms of collateral required to satisfy credit for reinsurance under the Credit for Reinsurance Model Law (Model 785), the Captive/SPV Subgroup recommends that such conditional letters of credit be studied further to determine whether they are providing the protections intended by this model law.

#### e. Financial Analysis Handbook Guidance

The Captive/SPV Subgroup suggests developing guidance to be included in the *Financial Analysis Handbook* to assist states' review of transactions involving captives and SPVs.

Upon finalizing the Captive White Paper after this comment period (and any further comment periods that the Captive/SPV Subgroup may elect to extend), the Captive/SPV Subgroup will be submitting it to its parent committee, the Financial Condition (E) Committee, for consideration.

### 2. FIO Announces Captive/SPV Task Force

The use of captives and SPVs to finance perceived reserve redundancies has also caught the attention of FIO. It was recently announced that the director of FIO, Michael McRaith, has called for the creation of a FACI task force to examine the issue. This effort was not particularly well received by certain state insurance commissioners, with some questioning the wisdom of this task force as being duplicative of efforts already underway at the NAIC. Superintendent Torti of Rhode Island added that any questions raised by this federal task force should necessarily involve the participation and input of NAIC member states.

### 3. Superintendent Benjamin Lawsky of New York Weighs In On Captives/SPVs

In a recent speech shortly after the Spring National Meeting, Superintendent Benjamin Lawsky of the NYDFS addressed insurance companies' use of captives/SPVs to "off-load risk and increase leverage." In his speech, he voiced concern that transactions with these captives/SPVs may not actually transfer risk off of the books of the ceding insurance company, potentially leaving insurance companies unable to handle losses. He indicated that the NYDFS is "hard at work" investigating the potential risks posed to policyholders by captives/SPVs.

## C. Separate Account Risk Working Group

The Separate Account Risk (E) Working Group ("SARWG") was created in 2009 in response to a recommendation by the Statutory Accounting Principles Working Group. In particular, the Statutory Accounting Principles Working Group was concerned with instances where an insurer's general account guaranteed individual separate account products without a corresponding risk charge. SARWG has been charged with (a) considering the need to modify existing guidance related to separate accounts and (b) comparing U.S. GAAP and SAP requirements relating to separate accounts. SARWG last met at the 2012 Summer National Meeting, at which time it decided that it would pursue regulator-only educational calls until its members determined that public conference calls should be resumed. When public conference calls resumed on January 9, 2013, SARWG released a document entitled "Non-Variable, Insulated Products / Product Characteristics with Proposed Recommendations" ("SARWG Exposure Document") for comment. The comment period ended on March 25, 2013.

The SARWG Exposure Document focuses on 21 non-variable, insulated products and seeks to identify whether those products' features support insulation from general account claims. The 21 non-variable, insulated products were identified by the Financial Analysis (E) Working Group in a confidential 2011 study and have been divided into six groups based on the products' attributes, including the investment components, performance aspects and variability of returns.

Once finalized, the SARWG Exposure Document will recommend to the Financial Condition (E) Committee whether revisions should be made to regulatory guidance regarding those products that are currently categorized as insulated products. Although SARWG did not meet at the Spring National Meeting, it is expected that a conference call will be held soon to discuss comments to the SARWG Exposure Document.

## III. Topics of Interest to the Property and Casualty Industry

### A. Creditor-Placed Insurance Still in the Spotlight

Creditor/lender-placed insurance ("LP Insurance"), which is insurance procured by a lender when its customer fails to carry or renew property hazard insurance on an asset in which the lender has a security interest, continues to garner attention of state insurance regulators and consumer advocacy groups.

As previously reported, consumer advocates have challenged the LP Insurance system and alleged that it contains impermissible kickbacks and inflated prices for policies. In response, the NAIC held public hearings during its 2012 Summer National Meeting.

During the Spring National Meeting, the Property and Casualty Insurance (C) Committee voted to approve revisiting the NAIC's Creditor-Placed Model Act to determine whether it (i) currently contains sufficient consumer safeguards, (ii) should be classified as a guideline rather than a model law[4] and (iii) should be amended or repealed/archived.

In related LP Insurance news, shortly prior to the Spring National Meeting, the NYDFS announced that it had reached a settlement with two of the country's largest providers of LP Insurance. The settlements include monetary penalties and the insurers' agreement to refund certain premiums to homeowners and to abide by certain practices going forward, including a prohibition on issuing LP Insurance on mortgaged property that is serviced by an affiliated bank or servicer.

Superintendent Lawsky of New York has reportedly urged his fellow state insurance regulators to use New York's settlement with these LP Insurance providers as a model for lowering LP Insurance rates nationally.

### B. Mortgage Guaranty Insurance Regulation Due for Update

The Mortgage Guaranty Insurance (E) Working Group ("MGI Working Group") met to discuss updating the regulation regarding solvency standards for mortgage guaranty insurers ("MGI"), including revising the Mortgage Guaranty Insurers Model Act ("MGI Model Act"), and to receive industry and consumer input regarding such potential changes. The MGI Working Group was formed in late 2012 and previously exposed a *Concepts-List of Potential Regulatory Changes* ("Concepts-List") for public comment. The Concepts-List includes a description of some of the significant items to address regarding the regulation of the MGI industry. The meeting was well attended, and discussion was lively both among regulators and the public. Deputy Insurance Commissioner Steve Johnson of Pennsylvania remarked early in the meeting

[4] From an NAIC process perspective, classifying the Creditor-Placed Model Act as a guideline would expedite any eventual amendments, as the required approval for adoption of any amendments to the Creditor-Placed Model Act in the form of a guideline is lower (i.e., a majority of NAIC member states) as compared with adopting amendments to a model law, which requires a supermajority of NAIC member states.

that he feels the MGI Working Group must make changes to the current MGI regulation. The majority of the discussion centered on the current MGI Model Act method for setting the cap on an MGI's total liability, net of reinsurance, at a 25-to-1 ratio for such liability as against the company's capital, surplus and contingency reserve. Regulators and industry both spoke in support of adding a levels-based approach to the regulatory evaluation of MGIs, like the action levels in RBC analysis, although it was also acknowledged that the leverage ratio should continue to be part of the analysis. Speakers for industry groups supported a more nuanced, company-specific analysis based on underwriting profiles.

### C. New Commercial Lines Working Group

The newly formed Commercial Lines (EX) Working Group ("Commercial Lines WG") met for the first time during the Spring National Meeting. The NAIC previously considered issues relating to commercial lines insurance in its 1998 publication of a *White Paper on Regulatory Re-engineering of Commercial Lines Insurance*, which considered how to streamline commercial lines insurance regulation. The Commercial Lines WG has been formed due to a request from the American Insurance Association that the NAIC look at these issues again. As part of its plan to provide feedback to the NAIC on how to make commercial lines regulation effective and efficient, the Commercial Lines WG approved a draft work plan that will (i) summarize existing state requirements for commercial lines rate and form filings, (ii) survey states' average time for approval of form and rate filings for various products, (iii) review the experiences of states that have undertaken commercial lines reform and (iv) receive input from interested parties regarding potential improvements to rate and form filings. The Commercial Lines WG aims to complete its work by the 2013 Fall National Meeting.

* * * * * * * * * * * * * * *

If you have any questions regarding this memorandum, please contact one of the following members of our Insurance Transactional and Regulatory Practice Group or the Willkie attorney with whom you regularly work.


| **Name** | **Phone** | **Email** |
|---|---|---|
| **New York** | | |
| Leah Campbell | 212-728-8217 | lcampbell@willkie.com |
| Michael Groll | 212-728-8616 | mgroll@willkie.com |
| Donald B. Henderson, Jr. | 212-728-8262 | dhenderson@willkie.com |
| Allison J. Tam | 212-728-8282 | atam@willkie.com |
| Gregory B. Astrachan | 212-728-8608 | gastrachan@willkie.com |
| Scott D. Avitabile | 212-728-8279 | savitabile@willkie.com |

| | | |
|---|---|---|
| Serge Benchetrit | 212-728-8798 | sbenchetrit@willkie.com |
| David K. Boston | 212-728-8625 | dboston@willkie.com |
| Thomas M. Cerabino | 212-728-8208 | tcerabino@willkie.com |
| Henry M. Cohn | 212-728-8209 | hcohn@willkie.com |
| Laura L. Delanoy | 212-728-8662 | ldelanoy@willkie.com |
| Alexander M. Dye | 212-728-8642 | adye@willkie.com |
| Mark Getachew | 212-728-8647 | mgetachew@willkie.com |
| William H. Gump | 212-728-8285 | wgump@willkie.com |
| Jeffrey Hochman | 212-728-8592 | jhochman@willkie.com |
| Arthur J. Lynch | 212-728-8225 | alynch@willkie.com |
| Leslie M. Mazza | 212-728-8245 | lmazza@willkie.com |
| Vladimir Nicenko | 212-728-8273 | vnicenko@willkie.com |
| Jeffrey R. Poss | 212-728-8536 | jposs@willkie.com |
| Robert S. Rachofsky | 212-728-8088 | rrachofsky@willkie.com |
| Richard L. Reinhold | 212-728-8292 | rreinhold@willkie.com |
| John M. Schwolsky | 212-728-8232 | jschwolsky@willkie.com |
| Steven A. Seidman | 212-728-8763 | sseidman@willkie.com |
| Robert B. Stebbins | 212-728-8736 | rstebbins@willkie.com |
| Adam M. Turteltaub | 212-728-8129 | aturteltaub@willkie.com |
| **London** | | |
| Nicholas Bugler | +44 207 153 1208 | nbugler@willkie.com |
| Joseph D. Ferraro | +44 207 153 1218 | jferraro@willkie.com |
| Judith Harger | +44 207 153 1232 | jharger@willkie.com |
| Jon J. Lyman | +44 207 153 1210 | jlyman@willkie.com |
| **Brussels** | | |
| Xavier Dieux | +32 2 290 1840 | xdieux@willkie.com |

**Paris**

| | | |
|---|---|---|
| Christophe H. Garaud | +33 1 53 43 4513 | cgaraud@willkie.com |
| Daniel Hurstel | +33 1 53 43 4523 | dhurstel@willkie.com |
| Daniel Payan | +33 1 53 43 4504 | dpayan@willkie.com |

**Washington, D.C.**

| | | |
|---|---|---|
| Christopher S. Petito | 202-303-1117 | cpetito@willkie.com |


Willkie Farr & Gallagher LLP is an international law firm with offices in New York, Washington, Paris, London, Milan, Rome, Frankfurt and Brussels. The firm is headquartered at 787 Seventh Avenue, New York, NY 10019-6099. Our telephone number is (212) 728-8000 and our facsimile number is (212) 728-8111. Our website is located at www.willkie.com.

April 26, 2013

Copyright © 2013 Willkie Farr & Gallagher LLP.