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CLIENT MEMORANDUM

NAIC Report: 2013 Summer National Meeting

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The 2013 Summer National Meeting ("Summer National Meeting") of the National Association of Insurance Commissioners ("NAIC") was held in Indianapolis, Indiana from August 24 – 27, 2013.

The NAIC's Solvency Modernization Initiative ("SMI") continues to advance changes to the U.S. system of insurance regulation. SMI developments at the Summer National Meeting included adopting a process for the evaluation of non-U.S. jurisdictions in connection with credit for reinsurance standards and moving forward with several corporate governance initiatives. In addition, state implementation of principles-based reserving ("PBR") is a priority at the NAIC. The hotly debated NAIC assessment of U.S. jurisdictions' regulation of insurance company-owned captives and special purpose vehicles also culminated in the adoption of a white paper and referral of specific action items to various committees.

The report below summarizes some of the activities at the Summer National Meeting that may be of interest to our clients in the insurance industry, as well as developments from NAIC interim meetings and conference calls as noted in this report.

I. TOPICS OF GENERAL INTEREST TO THE INSURANCE INDUSTRY **3**

A. The NAIC's Amended Credit for Reinsurance Model Law 3

1. Update Regarding State Adoption of the Amended Credit for Reinsurance Model Law 3
2. NAIC Finalizes Process for Evaluating Qualified Foreign Jurisdictions 3
3. Inaugural Meeting of Reinsurance Financial Analysis Working Group 5

B. Solvency Modernization Initiative Continues Regulatory Updates 6

1. Adoption of SMI White Paper 6
2. Amended HCA Accreditation Standards Set; States Continue Legislative Action 6
3. SMI Dashboard Debuts 7
4. NAIC and States Continue Work With Respect to ORSA 7
5. Corporate Governance Initiatives Moving Forward 8
   a) Corporate Governance Initiatives Respond to FSAP Suggestions 8
   b) NAIC Receives Industry Proposal on Model Law on Corporate Governance 9
   c) Corporate Governance Working Group Forms Subgroup to Amend Model Audit Rule 10

C. International Insurance Matters 10

1. Joint Forum Reports on Longevity Risk Transfer Transactions 10
2. IAIS's ComFrame Project Continues 11
3. IAIS/FSB Designation of G-SIIs 11

II. TOPICS OF INTEREST TO THE LIFE INSURANCE INDUSTRY **12**

A. Use of Captives and Special Purpose Vehicles 12

1. The Captives and Special Purpose Vehicles White Paper 12
2. Federal Insurance Office Director McRaith Encourages NAIC Study of Captives and SPVs 14
3. New York Releases Report on Captives/SPVs 14

B. PBR Implementation Moves Forward, But Not Without Criticism 14

C. Private Equity/Hedge Fund Investments in Life Insurers 16

III. BRIEFLY NOTED **17**

A. NAIC Supports TRIA Reauthorization 17

B. NAIC Comments on IAIS's Issues Paper on International Branches 17

C. NAIC Moves Forward on Mortgage Guaranty Insurance Model Update 18

I. TOPICS OF GENERAL INTEREST TO THE INSURANCE INDUSTRY

A. The NAIC's Amended Credit for Reinsurance Model Law

1. Update Regarding State Adoption of the Amended Credit for Reinsurance Model Law

The Reinsurance (E) Task Force ("Reinsurance Task Force") reported at the Summer National Meeting that 18 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 Law").[1] The Reinsurance Task Force reported that insurers domiciled in these states represent approximately 53% of the primary insurance premium written in the United States.

It was also reported that in addition to Florida and New York, Connecticut has now joined the list of states that have approved reinsurers for collateral reduction. To date, a total of 29 reinsurers have been certified by these three states as eligible for reduced collateral requirements.

2. NAIC Finalizes Process for Evaluating Qualified Foreign Jurisdictions

The Amended Credit for Reinsurance Model Law provides that, in order to be eligible for certification and collateral reduction, among other things, 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 must consider the NAIC's list of qualified jurisdictions in making this determination. While not expressly stated in the Amended Credit for Reinsurance Model Law, the intent is for states to be able to rely upon the NAIC's list of qualified foreign jurisdictions. Indeed, Florida's amended laws provide that the commissioner may make a determination as to a qualified foreign jurisdiction based upon the NAIC's findings. On the other hand, if a state approves as qualified a jurisdiction that does not appear on the NAIC's list of qualified jurisdictions, the state must thoroughly document the justification for its approval in accordance with the applicable criteria as set forth in the Amended Credit for Reinsurance Model Law.

The NAIC's process for reviewing non-U.S. jurisdictions is set forth in a document entitled "NAIC Process for Developing and Maintaining a List of Qualified Jurisdictions" ("Process"). The Process was finalized by the Reinsurance Task Force in early August 2013 and was formally adopted by the Executive (EX) Committee and Plenary at the Summer National Meeting.

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[1] These states are: Alabama, California, Connecticut, Delaware, Florida, Georgia, Indiana, Iowa, Louisiana, Maine, Maryland, Missouri, New Hampshire, New Jersey, New York, Pennsylvania, Rhode Island and Virginia.

The Process provides for an "evaluation methodology" consisting of the following components:

- *Laws and Regulations*: A review of a jurisdiction's laws and regulations to evaluate whether the jurisdiction has sufficient authority to regulate the solvency of its reinsurers in an effective manner.
- *Regulatory Practices and Procedures*: An evaluation of whether the jurisdiction effectively employs regulatory practices and procedures to support enforcement of its financial solvency laws and regulations.
- *Jurisdiction's Requirements Applicable to U.S.-Domiciled Reinsurers*: The jurisdiction under review is requested to describe and explain the rights, benefits and the extent of reciprocal recognition afforded by the non-U.S. supervisory authority to reinsurers licensed and domiciled in the United States.
- *Regulatory Cooperation and Information Sharing*: The jurisdiction is requested to provide an explanation of the supervisory authority's ability to cooperate, share information and enter into a memorandum of understanding with U.S. state insurance regulators, and to confirm their willingness to do so.
- *History of Performance of Domestic Reinsurers*: The jurisdiction is requested to provide a general description with respect to the historical performance of reinsurers domiciled in the jurisdiction; confidential company-specific information is not intended for review by the NAIC.
- *Enforcement of Final U.S. Judgments*: The jurisdiction is requested to provide a description of any restrictions with respect to the enforcement of final foreign judgments in the jurisdiction.
- *Solvent Schemes of Arrangement*: The jurisdiction is requested to provide a description of any legal framework that allows reinsurers domiciled in the jurisdiction to propose or participate in any solvent scheme of arrangement or similar procedure.

Now that the Process has been adopted, the Reinsurance Task Force will charge the newly formed Qualified Jurisdiction Working Group[2] with implementing the Process, beginning with an expedited evaluation of those four jurisdictions that were approved by Florida and New York prior to the NAIC's adoption of the Amended Credit for Reinsurance Model Law (*i.e.*, Bermuda, Germany, Switzerland and the United Kingdom). Under the expedited evaluation, the "Laws and Regulations" and "Regulatory Practices and Procedures" components of the evaluation methodology will be initially deferred.

[2] The Qualified Jurisdiction Working Group will report to the Reinsurance Task Force, which in turn will make recommendations to the Executive (EX) Committee.

California Deputy Insurance Commissioner John Finston is set to chair this new Qualified Jurisdiction Working Group. This working group intends to move swiftly to begin these reviews and anticipates that the NAIC will be in a position to grant "Conditional Qualified Jurisdiction" status for these four jurisdictions by year-end. Director Huff of Missouri, who is the Vice Chair of the Reinsurance Task Force, indicated that the Qualified Jurisdiction Working Group expects to issue its decision as to these four jurisdictions on the same day so as to avoid any competitive advantage a jurisdiction might enjoy as a result of receiving the qualified jurisdiction status ahead of another. This "Conditional Qualified Jurisdiction" designation may be elevated to a final qualification for each jurisdiction following completion of the full evaluation procedure. The conditional designation is permitted to last for one year, although the Qualified Jurisdiction Working Group may grant an extension.

For a limited time following the adoption of the Process, the NAIC may consider expediting the review of additional jurisdictions that have been approved by a state as qualified jurisdictions, provided that a state has completed its review of the foreign jurisdiction within 60 days of the adoption of the Process, has itself listed the foreign jurisdiction as a qualified jurisdiction, and has provided its report to the Qualified Jurisdiction Working Group confirming that it has completed a full review in accordance with evaluation methodology set forth in the Process.

Thereafter, jurisdictions will be considered for review by the Qualified Jurisdiction Working Group based upon certain "objective factors," including, but not limited to, ceded premium volume and reinsurance capacity issues raised by the states. The Process also states that priority will be given to requests from states and from those foreign jurisdictions specifically requesting an evaluation by the NAIC.

3. Inaugural Meeting of Reinsurance Financial Analysis Working Group

The Reinsurance (E) Financial Analysis Working Group ("Reinsurance-FAWG") held its inaugural meeting at the Summer National Meeting. This is a confidential, regulator-to-regulator only group established to provide advisory support and assistance to states in the review of non-U.S. reinsurers' "certified reinsurer" applications, and to support, encourage and promote multistate recognition of certified reinsurers.

Pennsylvania Deputy Insurance Commissioner Steve Johnson, chair of the Reinsurance-FAWG, reported that the working group will review the 29 reinsurers that have been approved by Connecticut, Florida and New York as certified and eligible for collateral reductions. The Reinsurance-FAWG's goal is to complete these peer reviews by year-end. The Reinsurance-FAWG will not itself have the authority to assign ratings or collateral requirements for reinsurers (that authority is reserved to the states).

From a process perspective, the state that has approved a reinsurer for reduced collateral will participate on the Reinsurance-FAWG's conference calls, during which the Reinsurance-FAWG will review the approving state's due diligence process. If the Reinsurance-FAWG agrees with, and votes to accept, the approving state's determination, other states could rely on this assessment without having to undertake their own review. This process serves to facilitate

multistate recognition of reinsurers eligible for reduced collateral requirements, and to promote uniformity among the states in this regard. As noted above, in addition to Connecticut, Florida and New York, 15 states have adopted the Amended Credit for Reinsurance Model Law but have not yet approved a certified reinsurer. Following this peer review, those states would be able to move quickly to approve any pending applications from such reinsurers, with reduced collateral requirements being put in place as soon as January 1, 2014.

B. Solvency Modernization Initiative Continues Regulatory Updates

1. Adoption of SMI White Paper

The NAIC describes SMI as "a critical self-examination of the United States' insurance solvency regulation framework and includes a review of international developments regarding insurance supervision, banking supervision, and international accounting standards and their potential use in U.S. insurance regulation." Beginning in 2008 and acting through the SMI process, the NAIC focused on five key aspects of solvency regulation: (a) capital requirements, (b) governance and risk management, (c) statutory accounting and financial reporting, (d) group supervision and (e) reinsurance. The U.S. regulators' decisions to implement changes or maintain the existing regulatory system in each of these areas are identified and explained in "The U.S. National State-Based System of Insurance Financial Regulation and Solvency Modernization Initiative" ("SMI White Paper"). The SMI White Paper was adopted by the Solvency Modernization Initiative (E) Task Force ("SMI Task Force") and the Financial Condition (E) Committee ("E Committee") voted to adopt the SMI White Paper at the Summer National Meeting.

Noting the several work products developed through the SMI, such as the amendments to the Model Insurance Holding Company Act ("Amended HCA"), the development of the Risk Management and Own Risk and Solvency Assessment Model Act ("ORSA Model Act"), and the proposed development of the Corporate Governance Model Act, interested parties have raised concerns that certain regulatory requirements are duplicative. Therefore, at the Summer National Meeting the E Committee charged the Risk Focused Surveillance (E) Working Group with identifying any regulatory redundancies that have been created as a result of the SMI, focusing specifically on the overlapping requirements imposed by the Amended HCA, the ORSA Model Act, and existing corporate governance requirements. When discussing the Risk Focused Surveillance (E) Working Group's review, Commissioner Torti emphasized that the review should not slow down any state's adoption of SMI-related laws.

2. Amended HCA Accreditation Standards Set; States Continue Legislative Action

Effective January 1, 2016, "significant elements" of the Amended HCA, which was adopted by the NAIC in 2010, will be required for states to maintain NAIC accreditation. These significant elements include (i) requiring that the ultimate controlling person of a regulated insurer file an annual enterprise risk report, (ii) authorizing regulator participation in supervisory colleges, (iii) authorizing greater access for regulators to enterprise risk information of insurer affiliates' books and records, (iv) requiring notice of divestiture of controlling interest in a domestic insurer and (v) expanding requirements

for notice of affiliate transactions (including reinsurance agreements, tax allocation agreements, and modifications of existing agreements). At the Summer National Meeting, it was proposed that the time line for effectiveness of the accreditation standards be accelerated to January 1, 2015. However, no support for the suggestion was demonstrated among members of the Financial Regulation Standards and Accreditation (F) Committee ("F Committee") or interested parties, and the F Committee voted to adopt the significant elements as accreditation standards, effective January 1, 2016.

Since the 2013 Spring National Meeting ("Spring National Meeting"), several states have adopted the Amended HCA, bringing the total number of states to 23.[3] The new jurisdictions are Georgia, Maine, Nevada, New Hampshire, Oklahoma, Oregon, Vermont, Wyoming and, most notably, New York.

3. SMI Dashboard Debuts

The SMI Task Force continued to discuss the development of an "SMI Dashboard." First announced at the Spring National Meeting, the SMI Dashboard will track the implementation of SMI-related model laws on a state-by-state basis. Currently, the SMI Dashboard tracks the implementation of the Amended HCA (and its related regulation), the ORSA Model Act, the Amended Credit for Reinsurance Model Law, and PBR implementation. The SMI Dashboard was made available online on September 5, 2013.[4]

4. NAIC and States Continue Work With Respect to ORSA

Both the NAIC and various state legislatures have continued to make progress in enacting and refining the requirements of the ORSA Model Act in advance of its proposed uniform effective date of January 1, 2015. Six states (California, Iowa, Maine, New Hampshire, Rhode Island and Vermont) have adopted the ORSA Model Act into law since September 2012. Legislation to implement the ORSA Model Act is pending in four other states (Connecticut, Ohio, Pennsylvania and Texas). Once adopted, the ORSA Model Act will require U.S. insurers with premiums in excess of certain thresholds to maintain a risk management framework and to regularly conduct an Own Risk and Solvency Assessment ("ORSA"). Insurers will document the results of their ORSAs through a highly confidential summary to their domiciliary regulators; such report is known as an "ORSA Summary Report." Although an insurer is required to regularly conduct an ORSA, its ORSA Summary Report will be submitted to applicable regulators no more than annually.

In 2012, the NAIC adopted both the Own Risk and Solvency Assessment Guidance Manual ("ORSA Guidance Manual") and the ORSA Model Act and conducted the 2012 ORSA Pilot Program. The 2012 ORSA Pilot Program resulted in a

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[3] California, Connecticut, Georgia, Idaho, Indiana, Kansas, Kentucky, Louisiana, Maine, Maryland, Mississippi, Nebraska, Nevada, New Hampshire, New York, Oklahoma, Oregon, Pennsylvania, Rhode Island, Texas, Vermont, West Virginia and Wyoming.

[4] Available at: http://www.naic.org/documents/committees_e_isftf_related_docs_smi_dashboard.pdf.

number of clarifying revisions to the ORSA Guidance Manual. Currently, the Own Risk and Solvency Assessment (E) Subgroup ("ORSA Subgroup") is conducting the 2013 ORSA Pilot Program. The 2013 ORSA Pilot Program is expected to produce 10-15 sample ORSA Summary Reports, which volunteer insurers will submit for review by September 30, 2013. Once the sample ORSA Summary Reports are received, they will be subject to confidential analysis by NAIC staff, members of the ORSA Subgroup, and other invited regulators. The 2013 ORSA Pilot Program will differ from the 2012 ORSA Pilot Program in that insurers will have additional time to prepare their sample ORSA Summary Reports and the NAIC will take additional time to review such reports. The results of the 2013 ORSA Pilot Program are expected to provide guidance to the NAIC regarding additional revisions to the ORSA Guidance Manual.

Following the Spring National Meeting, the F Committee released a proposal to make adoption of the ORSA Model Act an accreditation standard ("ORSA Accreditation Proposal"). At the Summer National Meeting, the F Committee voted to expose the ORSA Accreditation Proposal for an additional one-year comment period beginning on January 1, 2014. Although the ORSA Model Act is expected to have a uniform effective date of January 1, 2015, the F Committee's ORSA Accreditation Proposal is not anticipated to become an accreditation standard until 2017.

5. Corporate Governance Initiatives Moving Forward

a) Corporate Governance Initiatives Respond to FSAP Suggestions

The Corporate Governance (E) Working Group ("CGWG"), formed in 2009, was charged with developing high-level principles to be used for corporate governance oversight. The CGWG has spent several years studying corporate governance standards and best practices in the U.S., globally and as adopted by the International Association of Insurance Supervisors ("IAIS") in its Insurance Core Principles. As part of this process the CGWG has developed and adopted legal summaries and comparisons of corporate governance practices and requirements. The NAIC's policy decisions arising from these steps are intended to be consistent with the U.S. system of corporate governance regulation, aligned with international standards, and not unduly burdensome on the insurance industry. NAIC actions in this regard are, in part, responsive to the 2009 Financial Sector Assessment Program ("FSAP") of the United States, which identified five corporate governance-related enhancements for possible inclusion in the U.S. insurance regulatory system. A brief summary of these suggested enhancements, as well as the NAIC's proposed responsive actions, follows:

- Require insurers to maintain risk management systems to identify and control risk. The NAIC has implemented this suggestion by adopting the ORSA Model Act, discussed above;
- Develop suitability criteria for key insurance company personnel. This FSAP recommendation will be addressed by the CGWG's referral to the Financial Analysis Handbook (E) Working Group ("FAHWG") to consider adoption of procedures to ensure that insurance department analysts review biographical affidavits of key persons to ensure that such persons are suitable for their positions with the insurer;

- Establish requirements for ongoing notifications to insurance regulators regarding satisfaction of such suitability criteria. The NAIC plans to address this FSAP recommendation in the CGWG's proposed annual corporate governance filing, discussed below;

- Establish requirements or guidance for good corporate governance practices. This FSAP recommendation will be addressed in the CGWG's proposed model law requiring an annual corporate governance filing, discussed below; and

- Establish an internal audit function requirement. The NAIC plans to address this suggestion with the CGWG's proposed revisions to the Model Audit Rule, discussed below.

At the Spring National Meeting, a CGWG document entitled "Proposed Responses to a Comparative Analysis of Existing U.S. Corporate Governance Requirements" ("CGWG Proposal") was adopted by the CGWG, the SMI Task Force, and the E Committee. The CGWG Proposal includes two requests for Model Law Development: (i) the "Annual Reporting of Corporate Governance Practices of Insurers Model Act" and (ii) amendments to the Model Audit Rule requiring insurers to maintain an internal audit function. Prior to the Summer National Meeting, the CGWG was given the green light by the NAIC Executive (EX) Committee and Plenary to proceed with these model law proposals.

b) NAIC Receives Industry Proposal on Model Law on Corporate Governance

It appears that the Annual Reporting of Corporate Governance Practices of Insurers Model Act would establish standard disclosure requirements regarding insurers' corporate governance practices in order to provide regulators with information to enhance their risk-focused surveillance of insurers. Pending NAIC approval to proceed with developing a new model law, the CGWG invited the industry to prepare a first draft of the Annual Reporting of Corporate Governance Practices of Insurers Model Act. At the Summer National Meeting, the CGWG heard and discussed a presentation of the industry's proposed draft model act to confidentially submit corporate governance disclosures to regulators on an annual basis ("Industry Proposal").

The Industry Proposal calls for an annual filing to include discussion of policies and practices with respect to an insurer's corporate governance structure, board of directors and committees, and management. Noting that ORSA establishes corporate governance standards with respect to financial auditing and internal controls over financial reporting, the industry emphasized that its draft mirrored language in the ORSA Model Act to avoid redundancies in the filing requirements. The Industry Proposal provides that for the purposes of satisfying the filing requirements, insurers can provide the required information by reference to other reports and filings submitted to regulators.

Commissioner Donegan, the chair of the CGWG, committed to having a draft of the Annual Reporting of Corporate Governance Practices of Insurers Model Act ready for presentation at the 2013 Winter National Meeting ("Winter National

Meeting"), and a Drafting (E) Subgroup was formed to begin this work, chaired by Commissioner Donegan and including Pennsylvania, Indiana, and Ohio.

c) Corporate Governance Working Group Forms Subgroup to Amend Model Audit Rule

As discussed above, the 2009 FSAP included a recommendation to establish a requirement that U.S. insurers maintain an internal audit function. In order to address that recommendation, the CGWG included a request for Model Law Development in order to amend the Model Audit Rule with the CGWG Proposal. The CGWG's request for Model Law Development proposes requiring insurers with annual premiums in excess of $500 million to "maintain an effective internal audit function capable of providing the audit committee independent assurance in respect of the insurer's governance, risk management, and internal controls." An Internal Audit (E) Subgroup was formed at the Summer National Meeting to begin work on this item. Douglas Stolte, Deputy Commissioner of Financial Regulation of the Virginia Bureau of Insurance, was asked to volunteer to chair, and Connecticut, New York, and Iowa expressed interest in participating.

C. International Insurance Matters

The International Insurance Relations (G) Committee ("G Committee") heard a number of reports at the Summer National Meeting regarding the activities of various international regulatory bodies and initiatives.

1. Joint Forum Reports on Longevity Risk Transfer Transactions

In order to manage the risk that pension beneficiaries may live longer than expected, pension plans have begun purchasing longevity risk coverage. It was reported during the G Committee meeting that in August 2013 the Joint Forum of the Basel Committee on Banking Supervision, the International Organization of Securities Commissions and the IAIS released a consultative document titled "Longevity Risk Transfer Markets: Market Structure, Growth Drivers and Impediments, and Potential Risks" ("Joint Forum Report"). The Joint Forum Report analyzes this emerging longevity risk transfer market and makes several observations and recommendations. In particular, with respect to those jurisdictions in which longevity risks may be assumed by non-insurance companies, such as banks, the Joint Forum Report encourages policymakers and regulators to consider which sector is in the best position to bear and manage the risk, and which holders of the risk under their supervision have the appropriate knowledge, skills, expertise and information to manage it. The Joint Forum Report also encourages regulators to cooperate with respect to longevity risk transfer transactions both internationally and cross-sectorally in order to reduce possible regulatory arbitrage.

2. IAIS's ComFrame Project Continues

The IAIS has been working on the "Common Framework for the Supervision of Internationally Active Insurance Groups" ("ComFrame") since 2010, and is scheduled to complete its "Development Phase" by the end of 2013. The goal of the project has been to create a better and more integrated multinational regulatory framework for supervising Internationally

Active Insurance Groups ("IAIGs"). The objectives of ComFrame have been stated as including creating consistency across supervisory jurisdictions and reducing duplicative efforts among insurance regulators. By coordinating regulatory supervision and information sharing, it is intended that ComFrame will lessen the regulatory demands on IAIGs.

Following the release of a concept paper for public consultation in 2011, a draft of ComFrame was issued for public consultation in 2012. At the Summer National Meeting, it was announced that the IAIS has been setting up a ComFrame drafting group that is now working on a revised and cohesive draft of ComFrame. They hope to have the draft ready for presentation at the IAIS Annual Conference in Taipei in mid-October. If it is approved there, it will be issued for a 60-day public consultation, after which it will be finalized for the purposes of field testing. The IAIS is currently scheduled to adopt ComFrame in 2018.

The G Committee has released an August 2013 update of its position paper on ComFrame, which outlines the views of U.S. insurance regulators on the development of ComFrame, and it was stated at the Summer National Meeting that the general expectation is that the paper will be approved at the Winter National Meeting. The paper generally shows that U.S. regulators support the intention of developing ComFrame as a way to enhance supervision of IAIGs, but that they do not support any imposition of additional and duplicative regulatory requirements that are not in the best interests of consumers. It particularly notes the desire to reach a common level of effectiveness without the necessity of having identical rules globally.

3. IAIS/FSB Designation of G-SIIs

As a member of the Financial Stability Board ("FSB"), the IAIS also plays a significant role in determining which insurers should be designated as Global Systemically Important Insurers ("G-SIIs"). The FSB (originally formed by the G-20) is responsible for determining which banks, insurance companies and other financial institutions should be designated as Global Systemically Important Financial Institutions ("GSIFIs"), although it is a policy research and development organization and does not have legislative or direct regulatory power over any such entities. Each country's internal financial regulators make their own determination of what is a Systemically Important Financial Institution. Once those regulators make that determination, they may set specific laws, regulations and rules that would apply to those entities. G-SIIs are a subset of GSIFIs, and the IAIS is responsible for recommending policies relating to how G-SIIs should be determined and what regulations should specifically apply to G-SIIs.

As has been widely reported, in July 2013 the FSB, in consultation with the IAIS and national authorities, identified an initial list of nine G-SIIs[5] that will now face recommended tighter regulation. The nine insurers join 28 global banks that were designated as GSIFIs in autumn 2012, and were hit with substantially higher capital charges. We note that there has been some overlap between the list of G-SIIs already named, and those named or being considered for naming to the

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[5] Allianz SE, American International Group, Inc., Assicurazioni Generali S.p.A., Aviva plc, Axa S.A., MetLife, Inc., Ping An Insurance (Group) Company of China, Ltd., Prudential Financial, Inc. and Prudential plc.

list of systemically important institutions being determined by the Financial Stability Oversight Council ("FSOC") in the United States. The FSB has said that reinsurers will go through the same process next year, so the industry can expect to see G-SII/SIFIs in the reinsurance sector to be named in 2014.

Commissioner John Huff is a member of FSOC, and at the Financial Stability (EX) Task Force meeting he provided a report on FSOC's recent activities. He indicated that FSOC has in recent months revealed its own first designated globally significant insurers ("SIFIs"): AIG, GE Capital and Prudential. Prudential is contesting its designation. MetLife is in the final stage of being evaluated for designation. There has been significant regulator and industry concern that FSOC is too deeply steeped in bank regulation, does not truly understand the insurance industry and that FSOC's SIFI designations were premature.

II. TOPICS OF INTEREST TO THE LIFE INSURANCE INDUSTRY

A. Use of Captives and Special Purpose Vehicles

1. The Captives and Special Purpose Vehicles White Paper

The Captive and Special Purpose Vehicle Use (E) Subgroup ("Captive/SPV Subgroup") finalized its much talked about Captives and Special Purpose Vehicles White Paper ("Captive White Paper") on June 6, 2013. The Captive White Paper outlines the findings of the Captive/SPV Subgroup's study of the use of captives and special purpose vehicles ("SPVs") by life insurance companies or insurance company holding companies to transfer insurance risks, and offers a variety of recommendations. Although the Captive/SPV Subgroup did not meet during the Summer National Meeting, its presence was felt throughout the weekend as its various referrals/recommendations to other NAIC committees, task forces, working groups and/or subgroups were received.

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

- *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 regulators, the objective being to ensure uniformity in this area.

- *Credit for Reinsurance Model Law 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.

- *Accounting Considerations*: To develop possible solutions for addressing any remaining XXX and AXXX perceived redundancies prior to the effective date of PBR, which solutions should be "addressed directly as opposed to through the use of captives and SPVs."

- *Financial Analysis Handbook*: To develop guidance in the *Financial Analysis Handbook* for the states' review and ongoing analysis of transactions involving captives and SPVs.

- *Confidentiality, Disclosure and Transparency*:

  - To study the issue of confidentiality related to commercially owned captives and SPVs more closely, with the aim of providing "greater clarity regarding the specific reasons for and against the use of confidentiality for such entities;" and

  - To consider enhanced disclosure in ceding company statements regarding the impact of captive/SPV transactions on the financial position of the ceding insurer.

Following the Summer National Meeting, those committees that received these and other referrals from the Captive/SPV Subgroup will begin considering whether to accept in whole, or in part, any of the recommendations.

Additionally, during a July 2013 conference call the Financial Analysis (E) Working Group ("FAWG") unanimously adopted the following new charges relating to the use of captives/SPVs:

- Perform analytical reviews of transactions (occurring on or after a date as determined by the NAIC membership) by nationally significant U.S. life insurers to reinsure XXX and/or AXXX reserves with affiliated captives, SPVs, or any other U.S. entities that are subject to different solvency regulatory requirements than the ceding life insurers, to preserve the effectiveness and uniformity of the solvency regulatory system;

- For such transactions entered into and approved prior to this date and still in place, collect specified data in order to provide regulatory insight into the prevalence and significance of these transactions throughout the industry; and

- Provide recommendations to the domiciliary state regulator to address company-specific concerns and to the Principles-Based Reserving Implementation (EX) Task Force ("PBR Task Force") to address issues and concerns regarding the solvency regulatory system.

There was much discussion during this conference call surrounding these new charges, primarily with respect to whether these new charges might be intended to prevent a state from approving a captive/SPV transaction unless it has been approved by the FAWG. It was clarified, however, that these charges are in no way intended to inhibit a state's ability to approve such transactions; rather, these charges are intended to subject these transactions to a peer review.

Superintendent Joseph Torti of Rhode Island remarked that it was his hope that states would have an interest in presenting relevant information to the FAWG and in hearing other states' concerns and/or recommendations. Through this peer review process, Superintendent Torti suggested that best practices may emerge.

2. Federal Insurance Office Director McRaith Encourages NAIC Study of Captives and SPVs

It appears from reports that the Director of the Federal Insurance Office (FIO), Michael McRaith, who had previously announced a FIO-led study of the use of captives/SPVs, is now encouraging the NAIC to continue its work to establish standards for the use of captives/SPVs. State insurance commissioners have been critical of the proposed FIO study as an unnecessary duplication of efforts.

3. New York Releases Report on Captives/SPVs

In June 2013, the New York Department of Financial Services ("NYDFS") released its own report on captives/SPVs titled "Shining a Light on Shadow Insurance – A Little-Known Loophole That Puts Insurance Policyholders and Taxpayers at Greater Risk." In the report, the NYDFS expressed concerns about insurance companies' use of captives/SPVs in transactions that may "not actually transfer risk" off of the books of the ceding insurance company, potentially leaving insurance companies unable to handle losses and "put[ting] the stability of the broader financial system at greater risk." The report calls for an "immediate national moratorium" on captive reinsurance transactions while regulators study these transactions. The need for such a measure was questioned by Louisiana Insurance Commissioner and NAIC President James Donelon, citing the ongoing efforts of the NAIC to study and address any potential issues. Indeed, no such national moratorium has been implemented by the NAIC.

B. PBR Implementation Moves Forward, But Not Without Criticism

PBR, which 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, is comprised of three principal components: (i) the Model Standard Valuation Law, which was revised by the NAIC in 2009,[6] (ii) the Standard Nonforfeiture Law for Life Insurance, which was amended by the NAIC in August 2012 and (iii) a Valuation Manual, which was adopted by a supermajority of NAIC members in December 2012.

The PBR Task Force, which serves as the coordinating body for NAIC technical groups involved with projects related to the PBR initiative, has been busy in the period between the Spring National Meeting and the Summer National Meeting working to finalize the PBR implementation plan ("Implementation Plan") and a legislative brief and PBR "Questions and Answers" sheet ("Legislative Packet"). The Implementation Plan sets forth certain proposals designed to assist in

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[6] The 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.

implementing PBR, including training and additional resources for regulators. The Legislative Packet is designed to assist state insurance regulators as they work with their legislators to amend their respective standard valuation laws.

During conference calls held in July 2013, the PBR Task Force voted to adopt both the Implementation Plan and Legislative Packet. New York, which has been vocal in its criticism of PBR in its current form, abstained from these votes.

At the Summer National Meeting, the PBR Task Force appointed the PBR Implementation Review (EX) Working Group, which will coordinate financial analysis, examination and actuarial review procedures with respect to PBR implementation. Managing Actuary Mike Boerner of the Texas Department of Insurance will chair this new PBR Review Working Group. Other members of this working group are: California, Florida, Iowa, Kansas, Missouri, New York, Ohio and Rhode Island.

It was also reported that eight states have adopted laws implementing PBR. Arizona, Indiana, Louisiana, Maine, New Hampshire, Rhode Island and Tennessee have adopted both the amended Standard Nonforfeiture Law for Life Insurance and the amended Standard Valuation Law; Texas has adopted only the Standard Nonforfeiture Law for Life Insurance.

In related PBR implementation activities, it was also announced that the NAIC has hired Rector & Associates to assist the PBR Task Force with certain of its PBR charges, including analyzing life insurer-owned captive transactions and the potential regulatory treatment of these transactions in light of PBR, providing assistance on examinations, and assessing the level of resources needed for PBR implementation.

The PBR Task Force also discussed at the Summer National Meeting referrals from the Captive/SPV Subgroup regarding the interplay of captive/SPVs and PBR. The discussion of this agenda item prompted Steven Kinion, Director of the Delaware Insurance Department's Captive Bureau, to request that the charge in the Implementation Plan that calls for XXX and AXXX perceived redundancies to be addressed "without encouraging formation of significant legal structures utilizing captives …" be eliminated, or, at a minimum, be suspended pending further discussion. Director Kinion indicated that his concerns arise from the fact that, while the NAIC's study of captive/SPV transactions is still ongoing, the Captive/SPV Subgroup's recommendation and this charge in the Implementation Plan is effectively a moratorium on new captives/captive transactions. Director Kinion pointed out that this is in direct tension with the Delaware Insurance Code, which provides that "captive insurance companies can serve a valuable risk management function, and that their responsible utilization and the growth of the captive insurance industry in the State of Delaware are in the best interests of this State."[7] Superintendent Joseph Torti of Rhode Island, who co-chairs the PBR Task Force, responded that Director Kinion's suggestion would not be implemented and the charge would remain. Echoing the recommendation in the report of the NYDFS on captives/SPVs (see discussion above at section II.A.3), Executive Deputy Superintendent of the Insurance Division of the NYDFS Robert Easton suggested that Director Kinion not proceed with new captives/captive transactions while the NAIC's study is pending. Director Kinion respectfully rejected this suggestion. The discussion concluded with Commission William White of the District of Columbia noting that while the NAIC's study of the use of

[7] Delaware Ins. Code Title 18, Part I, Chapter 69, Section 6901(a).

captives and SPVs is underway, individual states must use their best judgment as to what they feel is the appropriate course of action.

Following the Summer National Meeting, on September 11, 2013, Superintendent Benjamin Lawsky of New York issued a letter to his fellow insurance regulators again criticizing PBR. In the letter, Superintendent Lawsky states that, in its current form, PBR represents an “unwise move away from reserve requirements that are established by formulas and diligence policed by insurance regulators.” Since PBR will become effective only 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, larger states like New York hold considerable influence over PBR implementation.

C. Private Equity/Hedge Fund Investments in Life Insurers

In May 2013 the FAWG proposed that its parent committee, the E Committee, form a new working group to study the increased interest in the life insurance industry by private equity funds. In its referral, FAWG identified possible best practices, as well as potential changes to state laws and regulations incorporating such practices based on NAIC models. These recommendations focus on the acquisition of control process, reinsurance and insurance regulators’ financial examination practices for life insurers. On July 17, 2013, the E Committee voted unanimously to establish the proposed Private Equity Issues (E) Working Group, which will be chaired by Deputy Commissioner Stolte of Virginia. This new working group did not meet during the Summer National Meeting.

Acquisitions of life insurers by private equity/hedge funds have already begun to see heightened policyholder protections imposed in connection with the acquisition process. In acquisition transactions approved earlier this year by New York, for example, the NYDFS required that, among other things, the life insurer’s risk-based capital be maintained at an amount not less than 450%, the acquiring party agree to establish a “backstop” trust account to be used to replenish the insurer’s risk-based capital level should it fall below the prescribed level, and regulatory approval be obtained for any material change in the plan of operations of the target life insurer, including in respect of investments, dividends or reinsurance.

III. BRIEFLY NOTED

A. NAIC Supports TRIA Reauthorization

Following the 9/11 terrorist attacks, the U.S. Congress enacted the Terrorism Risk Insurance Act (“TRIA”) in order to provide a federal backstop for insured losses caused by terrorist acts. Following two previous extensions, TRIA is currently set to expire on December 31, 2014. At the Summer National Meeting, the NAIC adopted a resolution expressing its support for reauthorization of TRIA. In the resolution, the NAIC noted that TRIA has enabled insurers to offer terrorism coverage and that its existence is required for the insurance marketplace to continue to insure against terrorist acts. The NAIC believes that reauthorization should occur as soon as possible in order to minimize potential

disruption to the insurance markets. In the event of a delay in TRIA reauthorization, the property and casualty market may experience temporary market disruptions with respect to policies that insure against terrorist acts and that provide coverage beyond December 31, 2013.

B. NAIC Comments on IAIS's Issues Paper on International Branches

In July 2013, the IAIS released a revised draft of its Issues Paper on Supervision of Cross-Border Operations through Branches ("Branch Issues Paper") for public comment. The Branch Issues Paper was developed following the conclusion of a survey of existing regulatory requirements. It is intended to both describe regulation of branches operating on a cross-border basis and identify any existing, related regulatory issues.

In its description of the Branch Issues Paper, the IAIS notes that once it is completed, the Branch Issues Paper may serve as the basis for future IAIS activities with respect to the regulation of branches. On an August 13th call of the G Committee, Commissioner Leonardi noted that there no longer seems to be a need for an IAIS standard with respect to branches. This statement was echoed by interested parties, who remain concerned by the IAIS's suggestion that the Branch Issues Paper may serve as a basis for future IAIS work with respect to branches. The G Committee also noted that, unlike previous drafts, the current Branch Issues Paper seems to be less biased against the use of branches. Although the bias against branches may have been reduced from previous drafts, interested parties noted that the Branch Issues Paper continues to falsely imply that branch operations are prohibited by many foreign jurisdictions.

Following the release of the Branch Issues Paper, the NAIC developed its own comments and a number of interested parties submitted comments to the NAIC. Interested party comments were discussed on an August 13, 2013 conference call of the G Committee. Ultimately, the G Committee voted to submit the comments as drafted to the IAIS in advance of the August 15th comment deadline.

C. NAIC Moves Forward on Mortgage Guaranty Insurance Model Update

The NAIC Mortgage Guaranty Insurance (E) Working Group continues to work on updating the regulation of mortgage guaranty insurers. In the interim since the Spring National Meeting, Executive & Plenary approved a request for Model Law Development. Wisconsin has taken the lead on drafting amendments to the existing Mortgage Guaranty Insurers Model Act but several states are involved in addressing different topics, including those named in the development request: capital requirements and paid-in capital, geographic concentration, investment limitations, reinsurance and the use of captive reinsurance, modifications to risk-to-capital and minimum policyholders position, and contingency reserves. It is expected that this language will be shared in September or October on a group conference call for discussion.

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.

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