CLIENT MEMORANDUM

NAIC Report: 2014 Spring National Meeting

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AUTHORS

Leah Campbell | **Michael Groll** | **Donald Henderson, Jr.** | **Allison Tam**

If the 2013 NAIC Fall National Meeting (the "Fall National Meeting") of the National Association of Insurance Commissioners (the "NAIC") could be described as unusually dramatic, the 2014 NAIC Spring National Meeting, held in Orlando, Florida from March 29 - April 1, 2014 (the "Spring National Meeting"), represented a return to the NAIC's typical form. Lacking the disagreement and dissent of December, the Spring National Meeting was business as usual.
A consistent theme at the Spring National Meeting was that the NAIC's work needs to proceed smoothly and efficiently in order to present the best defense of the state-based system of insurance regulation against encroachment by federal regulators and subjugation by international regulators abroad. Thus, the steady work of the NAIC continued apace, as discussed below.

I. TOPICS OF GENERAL INTEREST 3
A. NAIC Corporate Governance 3
B. International/Federal Update 4
1. Reorganization of the IAIS 4
2. Updates 5
C. Group Supervision and Corporate Governance 6
1. Reopening of the HCA 6
2. Corporate Governance Continues to Work on Model Laws 6
a) The Corporate Governance Model Act and Regulation are Exposed for Finalization 6
b) Corporate Governance Working Group Adopts Model Audit Rule Revisions 8
3. Progress Continues with Respect to the ORSA Model Act 8
D. Private Equity Acquisitions 9
E. Reinsurance 11
1. Amended Credit for Reinsurance Model Act Recap 11
2. Qualified Jurisdiction Working Group 12
3. Reinsurance Financial Analysis Working Group "Passports" 24 Reinsurers 12
II. TOPICS OF INTEREST TO THE LIFE INSURANCE INDUSTRY 13
A. Principles-Based Reserving and Life-Insurer-Owned Captive Transactions 13
1. PBR Implementation Recap 13
2. Life-Insurer-Owned Captive Transactions and the Rector Report 14
3. New York Weighs In...Again 15
4. NAIC Seeks to Make Special Purpose Captives Subject to the Standards for Traditional Multi-State Insurers Under the NAIC Accreditation Standards 16
III. BRIEFLY NOTED 17
A. TRIA Update 17
B. Mortgage Guaranty Insurance Update 18

I. TOPICS OF GENERAL INTEREST

A. NAIC Corporate Governance

Commissioner Tom Leonardi of Connecticut created some unexpected sparks at the Fall National Meeting when he made public his opinion on problems with NAIC governance. At that meeting, Commissioner Leonardi made a motion to immediately authorize the hiring of outside consultants to evaluate and provide recommendations to the NAIC. Debate was split, with strong speakers on both sides, until Commissioner Sandy Praeger of Kansas made a motion to call the issue to a vote before all regulators could voice their opinions. The vote was called, and went against Commissioner Leonardi's proposal, although an alternate proposal was passed that called for an internal committee to evaluate the advisability of hiring such a consultant.

At the Spring National Meeting, this new committee (known as the Governance Review (EX) Task Force) (the "GR Task Force") held its first meeting to address corporate governance issues at the NAIC. The GR Task Force, of which Commissioner Leonardi is a member, is tasked with the following: (i) reviewing the NAIC's governing documents and making recommendations as appropriate, and (ii) considering a recommendation to the Executive (EX) Committee (the "Executive Committee") regarding whether to engage an outside consultant to assist in the review. The GR Task Force is co-chaired by Director John Huff of Missouri and Commissioner Jim Donelon of Louisiana, and its other members are from California, Connecticut, Montana, Nevada, New Hampshire, North Carolina, Tennessee, Wisconsin and Wyoming. Director Huff remarked at the Spring National Meeting that they would "make every effort" to ensure commissioner-level participation in the GR Task Force. The meeting was extremely well-attended, with numerous regulators in the audience even if they were not members of the GR Task Force.

Director Huff stated that the initial feeling of the GR Task Force is that hiring an outside consultant "could certainly be a useful tool" and that a final decision on the matter is expected before the 2014 NAIC Summer National Meeting (the "Summer National Meeting"). He noted that the NAIC has undergone five changes to its bylaws in the past ten years, and that consultants were engaged for some of those revisions. Commissioner Leonardi stated that while the issues he had raised were "still very much out there," he would not be "going back" to the letter he had circulated on his views. He noted that the world is watching and referred to the need to consider the Federal Insurance Office ("FIO") and international perspectives on what happens at, and what is accomplished by, the NAIC.

Other commissioners spoke as well. Commissioner Wayne Goodwin of North Carolina stated that it is an appropriate time for changes to the bylaws, and that the NAIC needs "a more perfect union and a more transparent one." Director Andrew Boron of Illinois cited "significant threats" from federal regulators to encroach on the authority of the state-based system, and warned that NAIC members "must honestly evaluate ourselves to ensure we are ready to win." In order to do so, he said that the members must strengthen the NAIC, make it open and equitable, ensure all are heard and are able to engage, and ensure that assignments to lead NAIC groups are not used to punish or reward certain members. Other

regulator comments included that other not-for-profit organizations would not typically allow past presidents to continue involvement at a certain level.

The GR Task Force also welcomed input from interested parties on establishing its priorities, and several spoke at the meeting. The GR Task Force spent considerable time at the meeting on discussing proposed revisions to the NAIC Policy Statement on Open Meetings, which were later adopted by the Executive Committee and Plenary. These revisions are intended to make the NAIC more transparent, and a number of comments were received from interested parties. It was noted that the NAIC is headed in the right direction, and that the International Association of Insurance Supervisors (the "IAIS") is notably headed in the opposite direction with regard to transparency.

The NAIC has taken action in response to Commissioner Leonardi's concerns, and now seems to be presenting a carefully united front. The industry will doubtless appreciate all movements towards transparency at the NAIC, as well as support related measures that can only enhance the credibility of the NAIC in the eyes of the world.

B. International/Federal Update

Discussion at the Spring National Meeting of the international and group supervisory issues that had been so divisive at the Fall National Meeting was surprisingly quiet. The international sessions consisted mainly of brief updates on various topics. There was little discussion of, or pushback against, FIO beyond the frequent refrain that the NAIC must protect its state-based system against the encroachment of other regulators.

1. Reorganization of the IAIS

One topic of significance at the international sessions of the Spring National Meeting was the upcoming internal reorganization of the IAIS. Although the exact changes remain to be seen, it is expected that several existing subcommittees such as the Standards Observance Subcommittee and Supervisory Cooperation Committee will be disbanded in July, following the finalization of work on assessing corporate governance risk, as it is felt that their role will be adequately covered by peer review going forward. It was strongly implied at the meeting of the International Regulatory Cooperation (G) Working Group that at least one of the reasons for this change is IAIS's decision to divert resources to the development of global capital standards for various categories of insurers. Additionally, we understand that the IAIS subcommittee on solvency may also be disbanded at some point in the future. However, we also understand that a formal request is currently being made for the creation of a subcommittee to address group supervision issues, which would focus on and monitor implementation of the IAIS's Insurance Core Principles. Finally, it was also mentioned in several meetings that the IAIS is changing its rules in ways that will reduce transparency.

2. Updates

The IAIS completed its third public consultation on its draft of a Common Framework for the Supervision of Internationally Active Insurance Groups (commonly referred to as "ComFrame") at the close of 2013, and the IAIS Technical Committee is reviewing the comments provided in advance of its meeting in June 2014. The quantitative field testing phase kicked off in late March and will continue through May 2014, with subsequent durations to follow.

It was stated that the IAIS will release a new high-level position paper in April 2014 on its current thinking regarding the development of various global capital standards. This would essentially be an informational document for its observers and members advising them of the IAIS's general current position on the subject. It was reported at the Financial Stability (EX) Task Force (the "Financial Stability TF") that the Basic Capital Reserve standard is the top priority of the IAIS, which hopes that it will be approved by the G-20 in November 2014. Various remarks were made at the Spring National Meeting about the timeframe for preparing the global capital standards being too short.

The Federal Reserve Board ("FRB") is now an official member of the IAIS. There has been no public indication that the FRB has applied to join the IAIS Executive Committee.

The Financial Stability TF heard a report on the Financial Stability Board's ("FSB") non-bank, non-insurer designation process, at which Steve Junior of Wisconsin noted that the objective of that process is to capture other "shadow banking entities" such as finance companies, hedge funds, and broker-dealers. The Financial Stability TF heard discussion of progress regarding international recovery and resolution, including the creation of a dedicated IAIS working group that works with the IAIS Technical Committee and Financial Stability Committee. The NAIC and FIO are both members of this subgroup. However, the NAIC is not a member of the FSB's similar insurance cross-border crisis management group. These two groups are currently working out how they will confer and not be redundant or contradictory. The Financial Stability TF also heard a report that the Financial Stability Oversight Council ("FSOC") continues to discuss non-bank designations. It was noted that FSOC is required to re-evaluate its designations at least annually, and that the anniversaries of designated insurers will come up beginning in July 2014.

It was reported at the International Regulatory Cooperation (G) Working Group meeting that the NAIC and the Japanese insurance regulator (the Financial Services Agency of Japan) have entered into a new formal alliance to work together on insurance regulatory matters. It was further announced that the NAIC expects to sign a Memorandum of Understanding with Afghanistan in May, and that it has been advised that the United Arab Emirates also wishes to enter into one.

Insurers should continue to monitor these important international initiatives, and consider attending the NAIC International Insurance Forum in Washington, D.C. on May 13-14, 2014.

C. Group Supervision and Corporate Governance

1. Reopening of the HCA

The NAIC approved the Request for Model Law Development (in this subsection, the "Request") to reopen the NAIC Model Insurance Holding Company Act and Regulation (the "HCA") in order to "address issues that have arisen subsequent to the adoption of" the previous HCA amendments in 2010. The Group Solvency Issues (E) Working Group will be tasked with this charge. The Request notes that "[c]ommissioners have indicated a desire to consider further changes to this model. The specifics of such changes have yet to be determined, but it is an area where there is a high level of interest given the ongoing focus of group supervision nationally and internationally." The Request cites a very low likelihood that the proposed action would be completed within one year, but presents the possibility that state legislatures would adopt any resulting changes within three years. At the Executive Committee meeting, certain items were proposed as being central to the considered changes, including: (i) granting clear authority for states to act as lead group supervisor, (ii) granting direct authority over holding companies, and (iii) requiring group-wide financial reporting. At the Financial Condition (E) Committee (the "E Committee") meeting, it was reiterated that these items were to be a particular focus of the regulators working on the HCA amendments.

It was again noted at the Spring National Meeting that the reopening of the HCA should not deter states from taking legislative action to incorporate the 2010 HCA amendments, which will become part of the NAIC's accreditation standards (the "Accreditation Standards") as of January 1, 2016. Currently, about half of the U.S. states have adopted those Model amendments. In a number of states, the first "Form F" enterprise risk management reports are due in 2014.

Insurers must continue to monitor adoption of the 2010 HCA amendments in the laws of the various states for compliance purposes, but should also keep an eye on new developments regarding group supervision.

2. Corporate Governance Continues to Work on Model Laws

In 2013, the NAIC approved two Requests for Model Law Development from the Corporate Governance (E) Working Group ("CGWG"): one relating to the development of a new Corporate Governance Annual Disclosure Model Act (the "Corporate Governance Model Act") and one relating to proposed amendments to the existing Annual Financial Reporting Model Regulation (the "Model Audit Rule"). Activity with respect to both requests continued at the Spring National Meeting.

a) The Corporate Governance Model Act and Regulation are Exposed for Finalization

At the Spring National Meeting, the CGWG released a revised draft of the Corporate Governance Model Act for a comment period ending April 21, 2014. The Corporate Governance Model Act, which sets forth the procedural requirements and applicable confidentiality provisions with respect to a new corporate governance annual disclosure (the

"CGAD"), was revised to incorporate comments received from regulators and interested parties during its most recent exposure period. Although industry members have expressed concern that the CGAD will become overly prescriptive, the Corporate Governance Model Act explicitly states that the insurer or insurance group shall have discretion over its responses in the CGAD so long as it contains the material information necessary for the relevant regulator to understand the insurer or group's corporate governance structure, policies and practices. Insurers or insurance groups will be able to provide information required by the CGAD by cross-referencing to other filings submitted to the relevant insurance regulator or other filings made with other state or federal regulators.

The CGAD's substantive requirements will be governed by a newly proposed Corporate Governance Annual Filing Model Regulation (the "Corporate Governance Model Regulation"). After numerous objections by industry members and interested parties to the inclusion of the CGAD's substantive requirements in a guidance manual or other extra-legislative document, the CGWG developed the Corporate Governance Model Regulation. As with the Corporate Governance Model Act, the Corporate Governance Model Regulation attempts to provide insurers and insurance groups with flexibility in their responses. The Corporate Governance Model Regulation reiterates that the CGAD shall be completed in the format of the insurer's choice, and shall be customized to include the most relevant corporate governance information that will enable insurance regulators to understand its corporate governance structure, policies and practices. Further flexibility is built in by allowing the CGAD to be completed at the level of an individual legal entity, intermediate holding company, or ultimate controlling parent. The level at which reporting is made should be based on where corporate governance decisions are made, oversight provided, and governance accountability assessed. The CGWG noted that the issue of redundant reporting obligations is important to interested parties and, accordingly, once the Corporate Governance Model Act and Corporate Governance Model Regulation are adopted, the CGWG expects to send referrals to other working groups to streamline reporting requirements and remove redundancies.

The CGWG's draft Corporate Governance Annual Regulation sets forth a detailed list of topics that should be reported on in a CGAD. A CGAD shall include description of four key elements of corporate governance: (i) the insurer's corporate governance framework and structure; (ii) the policies and practices of the Board of Directors and significant committees; (iii) the policies and practices of senior management; and (iv) the processes by which the Board of Directors, its committees, and senior management ensure an appropriate level of oversight to the critical risk areas impacting the insurer's business activities. The Corporate Governance Model Regulation proposes several related subtopics that should be included in a response to each element. On March 6, 2014, the CGWG released the Corporate Governance Model Regulation for a comment period ending on April 21, 2014. The CGWG hopes that this exposure period will allow regulators and interested parties sufficient time to review the Corporate Governance Model Regulation and for regulators to consider whether additional instructions regarding the contents of the CGAD are necessary.

If both the Corporate Governance Model Act and the Corporate Governance Model Regulation are adopted, then the first CGAD will be due on or before June 1, 2016.

The development of the Corporate Governance Model Act and Regulation was one of the key components of the NAIC's Solvency Modernization Initiative, and it is now approaching finalization. Insurers must be sure to be familiar with the finalized form of these requirements, which will likely be a focus of significant scrutiny in their compliance evaluation in years to come.

b) Corporate Governance Working Group Adopts Model Audit Rule Revisions

In 2013, the CGWG began to revise the Model Audit Rule to incorporate two revisions that will require (a) insurers with annual direct written and unaffiliated premium of at least $500,000,000 and (b) insurers who are members of a group of insurers with more than $1,000,000,000 in annual direct written and unaffiliated premium, to maintain an internal audit function. The internal audit function will review an insurer's corporate governance, risk management and internal controls and provide reasonable assurance to the insurer's audit committee with respect to such controls. Insurers or insurance groups who do not meet the size thresholds requiring them to maintain an internal audit function are encouraged to conduct a self-review to determine whether an internal audit function is nonetheless warranted.

An insurer's audit committee will be responsible for overseeing the internal audit function; this responsibility extends to granting authority and resources to the persons charged with performing the internal audit. The internal audit function must remain organizationally independent, and the individual appointed to head the internal audit function must have direct and unrestricted access to the board of directors. Additionally, the head of the internal audit function must report to the audit committee regularly, and no less than annually, on a number of items including material findings from previous audits and factors that may adversely impact the internal audit function's independence or effectiveness.

The CGWG and, subsequently, the E Committee adopted the revisions to the Model Audit Rule at the Spring National Meeting. The revisions to the Model Audit Rule are expected to be adopted by the Executive Committee and Plenary at or before the Summer National Meeting; after such adoption, the Model Audit Rule revisions will move to the states for adoption. If adopted, the requirements relating to the internal audit function will become effective on January 1, 2016.

Insurers should monitor adoption of these amendments to the Model Audit Rule by the states.

3. Progress Continues with Respect to the ORSA Model Act

State legislators and the NAIC continue to make progress with respect to the implementation of the Risk Management and Own Risk and Solvency Assessment Model Act (the "ORSA Model Act"), which is scheduled to become effective on January 1, 2015. The ORSA Model Act will require U.S. insurers who exceed specified premium thresholds to maintain a risk management framework, regularly conduct an own risk and solvency assessment ("ORSA"), and document the results of the ORSA in a summary report (an "ORSA Summary Report"). The ORSA Summary Report will be submitted confidentially to regulators on an annual basis.

As reported at the Spring National Meeting, NAIC staff surveyed member jurisdictions in spring 2014 regarding plans to adopt the ORSA Model Act. Forty-three jurisdictions responded to the survey. Based on the survey results, eight jurisdictions had already adopted the model, 18 jurisdictions intended to adopt the model, and two jurisdictions intended to adopt the model with revisions. Fifteen jurisdictions were undecided.

States to have adopted the ORSA Model Act currently include California, Indiana, Iowa, Maine, New Hampshire, New York, Pennsylvania, Rhode Island, Tennessee, Vermont, Virginia and Wyoming. States where legislation has been introduced to adopt the ORSA Model Act currently include Connecticut, Illinois, Kentucky, Minnesota, Missouri, Nebraska, Ohio, Texas, Washington and Wisconsin.

Additionally, the Own Risk and Solvency Assessment (E) Subgroup ("ORSA Subgroup") announced on its January 30, 2014 conference call that it had recently completed its 2013 Own Risk and Solvency Assessment (ORSA) Feedback Pilot Project. Twenty-two insurers voluntarily submitted confidential ORSA Summary Reports for regulatory review; a number of participants had previously volunteered for the 2012 ORSA pilot project. The ORSA Subgroup is currently conducting a third pilot project for 2014. In past pilot projects, the ORSA Subgroup has received and reviewed all of the ORSA Summary Reports. For this year's pilot project, the ORSA Subgroup intends for lead state regulators to become more involved. Lead state regulators will reach out to groups that they supervise and solicit volunteers. The states will then receive and review the ORSA Summary Reports and provide a report to the ORSA Subgroup.

The ORSA Subgroup will continue to develop and refine guidance relating to the ORSA Model Act between now and the ORSA Model Act's effective date of January 1, 2015.

D. Private Equity Acquisitions

On March 30, 2014, the NAIC's Private Equity Issues (E) Working Group (the "PE Working Group") met at the Spring National Meeting. The PE Working Group was formed in response to concerns from regulators regarding acquisitions of life insurance companies by private equity and hedge fund buyers.

The PE Working Group's first meeting was at the end of last year. At that meeting, there was a presentation from Athene/Apollo, which had recently acquired the U.S. life and annuity business from Aviva plc. The PE Working Group also exposed for comment a paper, which was developed by the NAIC's Financial Analysis Working Group ("FAWG"), with suggestions regarding best practices for acquisitions by private equity and hedge fund buyers.

At the Spring National Meeting, the PE Working Group focused on discussing the best practices set forth in the FAWG paper. Deputy Commissioner Stolte, Chairman of the PE Working Group, started the meeting by noting that no other private equity group/hedge fund, other than Athene/Apollo, had offered to speak at the PE Working Group or provide comments to the FAWG paper.

Deputy Commissioner Stolte also stated that the PE Working Group would develop best practices guidance for the NAIC's Financial Analysis Handbook that would help regulators during their review of acquisition of control applications. Deputy Commissioner Stolte indicated that this guidance should be "wrapped up by year-end." He also noted that this guidance should not be targeted at the particular "type of entity" and "should not frustrate private equity" investment in insurers. Instead, he stated that the analysis should be based on the risks posed by the particular entity acquiring the insurance company. Deputy Commissioner Stolte also indicated that the PE Working Group would defer any discussion of changes to regulations or model laws at this time and focus instead on the guidance for the NAIC Financial Analysis Handbook.

Deputy Insurance Commissioner Johnson, who played an active role in drafting the FAWG paper, recommended that the PE Working Group gather all the state insurance department orders issued in connection with recent acquisitions by private equity buyers and use those orders as examples when writing the narrative guidance for the NAIC Financial Analysis Handbook. He also indicated that there should not be a "cookie cutter" approach because each acquiring party is different and unique.

The PE Working Group then went on to discuss some of the proposed best practices in the FAWG paper. One suggestion in the FAWG paper was to include a demonstration that the policyholders are fundamentally more secure after the proposed acquisition. In its comment letter, Athene argued that there were adequate protections under the existing standards in the insurance holding company acts (*e.g.*, the policyholders will not be prejudiced). The members of the PE Working Group seemed to understand Athene's concern. Michael Maffei of the New York Department of Financial Services ("NY DFS") noted that circumstances can change quickly after an acquisition and that New York requires resubmission of the plan of operations submitted with the application to acquire control if material changes are made following the acquisition. Mr. Maffei suggested that this be a recommendation as a best practice and "not just for private equity" so there is "a level playing field." Other regulators commented that there should be a better understanding of how ownership by a private equity or hedge fund is different from ownership by a traditional insurance holding company.

The FAWG paper also suggests that an acquiring entity provide *pro forma* financials for the insurer and the group under certain stress scenarios. Deputy Insurance Commissioner Johnson indicated that this stress testing could apply to any type of acquisition and not just those involving private equity. He also indicated that "this is what the Feds are asking banks to do."

Another suggestion in the FAWG paper was to require a capital maintenance agreement from an acquiring party. Certain members of the PE Working Group expressed concern as to whether these types of agreements are "enforceable," but others seemed to support the suggestion.

There was also discussion of the recommendation in the FAWG paper that targeted examinations be done of the insurer and its affiliates. Such a targeted examination could include a review on a "granular basis" of the investment portfolio of the insurer and its affiliates. Members of the PE Working Group seemed to support this suggestion and indicated that control under the insurance holding company act is not only through ownership of voting securities but also through other

means as well, and that understanding the holding company structure and the investment approach is very important. Another suggestion for targeted examinations in the FAWG paper was for examinations of non-affiliated insurers where the direct writer has ceded a material portion of the annuity risk to a private-equity controlled insurer. Athene objected to this proposal in its written comments, stating that "insurance departments have broad authority to review reinsurance transactions with both affiliates and third parties." Certain members of the PE Working Group, however, expressed concern that regulators do not often look at the assuming insurer side of the reinsurance transaction and, at times, the assuming insurer is not really unaffiliated.

The PE Working Group indicated that the next steps are for the NAIC staff to develop guidance for the NAIC Financial Analysis Handbook based on the discussion that occurred at this meeting. A member of the PE Working Group also asked the staff to perform a benchmarking exercise to compare asset information for the general insurance industry as compared to private equity/hedge fund owned insurance groups.

Potential acquirers of insurance companies should carefully monitor the development of these best practices for the NAIC Financial Analysis Handbook since they are likely to apply to all acquirers of insurance companies and not just to private equity or hedge fund buyers.

E. Reinsurance

1. Amended Credit for Reinsurance Model Act Recap

The Reinsurance (E) Task Force ("Reinsurance Task Force") announced that as of the Spring National Meeting the NAIC's amendments to its Credit for Reinsurance Model Law and Regulations (the "Amended Credit for Reinsurance Model Act"), which allow for reduced reinsurance collateral requirements for unauthorized reinsurers, has been adopted by 19 states.[1] Insurers domiciled in these states represent over 50% of the primary insurance premium written in the United States. The Reinsurance Task Force also reported that a further nine jurisdictions are considering adopting the Amended Credit for Reinsurance Model Act or have legislation pending.[2]

Under the Amended Credit for Reinsurance Model Act, reinsurers domiciled in countries found by the NAIC to have strong systems of domestic insurance regulation (*i.e.*, "qualified jurisdictions") are eligible to apply for "certified reinsurer" status in states that have adopted the amendments. In addition, in order to qualify as a "certified reinsurer," an applicant must also meet certain criteria as to financial strength and reliability as provided in the Amended Credit for Reinsurance Model Act. Certified reinsurers are permitted to post collateral at reduced levels, and U.S. ceding insurers are permitted to take full financial statement credit for the reinsurance obligations of such certified reinsurers.

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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 Mexico, New York, Pennsylvania, Rhode Island and Virginia.

[2] These states are: Colorado, District of Columbia, Hawaii, Illinois, Massachusetts, Michigan, Ohio, Texas and Vermont.

As is required by the Amended Credit for Reinsurance Model Act, the reduced collateral amounts will be re-examined in 2014. The Reinsurance Task Force intends to undertake this re-examination by surveying those states that have adopted the Amended Credit for Reinsurance Model Act. Following this survey and review, the Reinsurance Task Force will make a recommendation as to what changes, if any, are needed to the collateral amounts set forth in the Amended Credit for Reinsurance Model Act.

2. Qualified Jurisdiction Working Group

In order to allow those states that have adopted the Amended Credit for Reinsurance Model Act to implement the reduced collateral requirements, the Qualified Jurisdiction (E) Working Group (the "Qualified Jurisdiction Working Group") has been working diligently to complete and continue its review of foreign jurisdictions for certification as "qualified jurisdictions." As previously reported, at the Fall National Meeting the Qualified Jurisdiction Working Group announced that it had completed its expedited review of the international supervisory authorities of Bermuda (Bermuda Monetary Authority), Germany (German Federal Financial Supervisory Authority), Switzerland (Swiss Financial Market Supervisory Authority) and the United Kingdom (Prudential Regulation Authority of the Bank of England). This expedited review resulted in a "Conditional Qualified Jurisdiction" designation, and the Qualified Jurisdiction Working Group intends to complete its full evaluation procedure for these four jurisdictions in 2014. The Qualified Jurisdiction Working Group also will be reviewing Ireland and France in 2014 for eligibility as "qualified jurisdictions." It was further noted at the Reinsurance Task Force meeting that two additional, though unnamed, jurisdictions have been invited by the Qualified Jurisdiction Working Group to participate in this evaluation process.

3. Reinsurance Financial Analysis Working Group "Passports" 24 Reinsurers

The Reinsurance (E) Financial Analysis Working Group (the "Reinsurance-FAWG"), which 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, reported during the Reinsurance Task Force meeting at the Spring National Meeting that it had reviewed and approved, or "passported," a total of 24 reinsurers that had previously been certified and eligible for collateral reductions by the states of Connecticut, Florida or New York, with two additional reinsurers currently in the queue for review in 2014. This "passporting" signifies that the Reinsurance-FAWG agreed with, and voted to accept, the approving states' determination, and other states may now choose to rely on this assessment without having to undertake their own independent review of these reinsurers.

Deputy Insurance Commissioner Johnson, chair of the Reinsurance-FAWG, also reported that the Reinsurance-FAWG has developed, and exposed for a thirty-day comment period, a "Uniform Application Checklist for Certified Reinsurers" that will serve to streamline the process for reinsurers seeking to apply for certified status.

Deputy Insurance Commissioner Johnson reiterated that since the “passported” status is only valid for one year, the Reinsurance-FAWG will be working in 2014 to develop a renewal process whereby it will review the financial condition of passported reinsurers.

Deputy Insurance Commissioner Johnson also noted a “wrinkle” in the passporting process that the Reinsurance-FAWG will be working to iron out in the near term. This wrinkle stems from the fact that a reinsurer that has been “passported” would nonetheless not be able to qualify for reduced collateral requirements in a state that does not have a memorandum of understanding in place with the reinsurer’s jurisdiction of domicile. The Reinsurance-FAWG intends to explore with the states both a multi-lateral as well as a one-off approach to these memoranda of understanding with the qualified jurisdictions.

Statewide implementation of the Amended Credit for Reinsurance Model Act continues at a steady pace, and the NAIC remains hard at work through the “qualified jurisdiction” and certified reinsurer “passporting” process to ensure that reinsurers are able to take full advantage of the reduced collateral requirements.

II. TOPICS OF INTEREST TO THE LIFE INSURANCE INDUSTRY

A. Principles-Based Reserving and Life-Insurer Owned Captive Transactions

1. PBR Implementation Recap

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. PBR is comprised of three principal components: (i) the Model Standard Valuation Law, which was revised by the NAIC in 2009, (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. At the Spring National Meeting, it was reported that nine states have enacted legislation to adopt the amended Model Standard Valuation Law, with a further four states awaiting signature by their state governor. It was also reported that an additional nine states will be considering the amended Model Standard Valuation Law in 2014, and a further seven are expected to consider it in 2015. If all of these states were to enact PBR implementation legislation, the NAIC reported that this would represent 29 states and approximately 60% of applicable U.S. premium. PBR will only become effective, however, 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.

At the Spring National Meeting, the Life Actuarial (A) Task Force exposed for comment a draft proposal put forth by the American Council of Life Insurers (the “ACLI”) regarding PBR considerations for small companies. Under the proposal, small companies would be exempt from having to compute stochastic or deterministic reserves on any of their ordinary life policies. The ACLI suggests defining a “small company” as one having less than $300 million of ordinary life premiums or,

if the company is a member of an NAIC group of life insurers, a company having less than $600 million of ordinary life premiums. Under the proposed plan, in order to qualify for an exemption, such small companies would be required to have reported a risk-based capital (RBC) ratio of at least 450% and any of their issued or assumed universal life policies with secondary guarantees ("ULSG") would have to meet the proposed definition of "non-material secondary guarantee," *i.e.*, a secondary guarantee that provides a nominal guarantee to an accumulation-based ULSG.

2. Life-Insurer-Owned Captive Transactions and the Rector Report

Following the release on February 17, 2014 of the second installment of the report from Rector & Associates, Inc. (the "Rector Report"), the meeting of the Principles-Based Reserving Implementation (EX) Task Force (the "PBR Task Force") at the Spring National Meeting was once again largely focused on the debate over life insurer reserve relief effected through insurer-owned captive transactions.

Rector & Associates, Inc. was hired by the PBR Task Force to assist it 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, and assessing the level of resources needed for PBR implementation.

The Rector Report proposes recommendations with respect to reserve financing transactions associated with level premium term life insurance policies (*i.e.*, Regulation XXX reserves) and universal life insurance policies with secondary guarantees (*i.e.*, Regulation AXXX reserves). Following the release of the initial Rector Report on September 13, 2013, the general consensus that emerged was that these captive/special-purpose vehicle ("SPV") XXX and AXXX reserve financing transactions should be permitted until PBR becomes effective. The second installment of the Rector Report therefore explores in greater detail certain recommended criteria for these transactions until such time as PBR becomes effective.

Significantly, the Rector Report recommends that the focus ought to be on the direct/ceding insurer and not the assuming captive reinsurer. The Rector Report suggests that by doing so, it minimizes the ability of ceding insurers to simply move these transactions to offshore assuming entities in order to avoid regulatory oversight. A related concern was voiced by Utah Commissioner Todd Kiser during the meeting of the Financial Regulation Standards and Accreditation (F) Committee (the "Accreditation Committee") in connection with the proposal to subject these captives to more comprehensive regulation by expanding the definition of "multi-state insurer" in the context of the Accreditation Standards to include insurer-owned captives and SPVs. Commissioner Kiser suggested that this change may only serve to move these transactions offshore and further out of reach of state regulatory oversight as a large percentage of sponsors of U.S. domiciled captives would simply use offshore captives rather than domestically domiciled ones.

Further to the notion of regulating the ceding company rather than the captive reinsurer, one of the key recommendations of the Rector Report is that the ceding company only be permitted to finance Regulation XXX and AXXX reserves if the assets held in a reinsurance trust or on a funds-withheld basis to back the XXX/AXXX reserves are comprised of "Primary

Assets." The Rector Report proposes that "Primary Assets" be comprised of (i) cash and (ii) securities that are listed by the SVO and qualify as admitted assets. The Rector Report also proposes that clean, irrevocable, unconditional and evergreen letters of credit may be used but only (a) to fill the gap that may result from market fluctuations of the Primary Assets and (b) if such letters of credit represent no more than 10% of the insurer's total Primary Asset level. The Rector Report further proposes that the method by which the amount of reserves required would be determined could be a modified version of the PBR approach as set forth in the NAIC's Valuation Manual. The Rector Report recommends that assets used to support amounts in excess of the amount required by this actuarial method could be in the form of non-admitted assets.

In lieu of the use of reinsurance (including the use of captives/SPVs) to finance XXX/AXXX reserving, the Rector Report also supports an approach whereby assets and liabilities are kept on the insurer's balance sheet, perhaps by using a protected cell structure or a separate account. The Rector Report notes, however, that this alternative presents structural issues that would likely require changes to existing state insurance laws/statutory accounting rules in order to permit the segregation of assets and liabilities associated with these reserves.

The Rector Report also sets out a proposed timeline for the implementation of its recommendations. Namely, the Rector Report suggests that proposed new standards could begin to be applied for XXX/AXXX financing transaction structures newly created on and after July 1, 2014 and with respect to any XXX or AXXX business written by the direct insurer on or after January 1, 2015, regardless of when the financing structure/vehicle was created.

It is important to note that the Rector Report recommendations have not been adopted or implemented by the NAIC and that discussions surrounding the Rector Report's recommendations continue. The depth and spread of disagreement over the Rector Report's recommendations remains significant, and resolution of these disagreements in the near term appears unlikely. In this regard, the PBR Implementation Task Force plans to hold one or more conference calls to continue to debate and assess the Rector Report's proposals, with one such call currently scheduled for April 14, 2014

3. New York Weighs In…Again

Not surprisingly, the Rector Report was met with swift criticism by Superintendent Benjamin Lawsky of the NY DFS. Superintendent Lawsky, a long-time opponent of PBR, characterized the Rector Report as a "Trojan horse" that would advance the risky PBR approach that he has been warning his fellow regulators against adopting.

Superintendent Lawsky has called these XXX/AXXX financing transactions a "shadow insurance" industry because of what he perceives to be a lack of regulatory oversight. Moreover, Superintendent Lawsky has made clear time and again that he would not support PBR as he believes it would weaken consumer protections by giving insurers too much leeway to reduce reserves to potentially dangerously low levels that could ultimately reduce policyholder security and lead to an increase in insurer insolvencies. Until recently, however, while Superintendent Lawsky had been critical of PBR, a concrete alternative had not been advanced. That changed on March 27, 2014 when Superintendent Lawsky announced

that New York had developed a revised formula for level term products (*i.e.*, those backed by XXX reserves). The revised reserving formula would be effective for new business written in New York after January 1, 2015 and, according to Lawsky, "reflects actuarially sound and evidence-based adjustments regarding mortality data and expenses" and will result in a 30-35% reduction in reserves for these products on a prospective basis. DFS has indicated that it intends to issue a regulation in coming weeks that will update the reserving formulas. Superintendent Lawsky has also signaled that updated formulae for universal life insurance policies with secondary guarantees (*i.e.*, those backed by AXXX reserves) are to follow. By taking the lead on revising these reserving formulae, Lawsky is attempting to demonstrate to his fellow regulators and the life insurance industry that properly formulated traditional reserving can accommodate actual or perceived redundant reserve requirements without the need for either captive financing transactions or PBR.

4. NAIC Seeks to Make Special Purpose Captives Subject to the Standards for Traditional Multi-State Insurers Under the NAIC Accreditation Standards

The NAIC Financial Regulation and Accreditation Program is a process by which accreditation is given to a state insurance department if it meets certain legal, financial and organizational standards as determined by peer regulators. Such standards include adopting certain Model laws and regulations developed by the NAIC.

During the Accreditation Committee meeting, draft revisions to the Accreditation Standards with respect to state regulation of insurer-owned captives and SPVs were exposed for a 45-day comment period. The proposed amendments are aimed at including within the definition of "multi-state insurers" those insurer-owned captives and SPVs that are single-state licensed but assume reinsurance from cedants operating in multiple states, thereby subjecting them to all the Accreditation Standards applicable to other insurers. This would mean that states that have licensed such entities would have to revise their existing laws in order to apply, among other items, the capital and surplus requirements, risk-based capital requirements, investment laws and credit for reinsurance laws that are applicable to traditional multi-state insurers to the extent such existing laws have different capitalization, reinsurance and related standards applicable to these insurer-owned captives and SPVs.

In order to avoid significant disruption in the marketplace and in order to allow states to revise their existing laws in order to comply with the Accreditation Standards, any such amendments to the multi-state insurer definition are proposed to be prospective in nature and likely would include a seasoning period prior to the proposed changes coming into effect. In addition, it was noted during the Accreditation Committee meeting that any such captive/SPV that otherwise meets any new standards applicable to XXX/AXXX financing transactions (as outlined in the Rector Report and discussed above) would be deemed compliant with the requirements applicable to traditional multi-state insurers.

Reactions during the Accreditation Committee meeting to the proposed amendment were strong and divided. Commissioner Leonardi remarked that the "captive issue is one of if not the most significant issue to be resolved," but cautioned that attempting to fix the issue overnight would not serve the NAIC or the industry well. While recognizing the "sticker shock" the proposed amendment may cause among regulators and the industry, Rhode Island Superintendent

Joe Torti, who had originally proposed the change, stressed that the accreditation system is the single most important aspect of the NAIC as it serves to achieve nationwide regulatory uniformity. Superintendent Torti went on to state that the NAIC has exposed a "gaping hole in the regulatory fabric" in the lack of regulatory and solvency oversight that currently exists with respect to these insurer-owned captives and SPVs. Superintendent Lawsky aligned himself with Superintendent Torti's comments, and added that the "stakes are as high as they get for the insurance industry and the NAIC," and that New York was ready to proceed with the proposed amendments. Commissioner Julia Rathgeber of Texas added that an important recurring theme that has emerged from both the industry and FIO is the need to regulate uniformly and, accordingly, she expressed support for the proposed amendment. Commissioner Kiser, on the other hand, warned that should these amendments be implemented, it was likely that domestic insurers would instead utilize offshore captives rather than domestically domiciled ones and that the NAIC should be prepared for those consequences. Utah is the second largest state in terms of domestically domiciled captives. Vermont Deputy Commissioner of Captive Insurance David Provost commented that he found the proposed amendment "confusing" in that it appeared to include certain entities that should not be included and exclude certain entities that should have been included. Deputy Commissioner Provost indicated that Vermont would be submitting comments to the proposed amendment in due course. Industry response was also strong, with Paul Graham from the ACLI calling the proposed amendment "troubling" and "problematic." Mr. Graham observed that if these unique, single-state licensed entities are to be subject to the same standards as traditional multi-state insurers, then the proposed amendment would effectively impose a moratorium on the formation of most new insurer-owned captives/SPVs. This potential effect was no doubt not lost on Superintendent Lawsky, who last year had proposed an outright moratorium on life insurer reserve relief effected through insurer-owned captive transactions.

PBR implementation and the related life-insurer owned captive transactions remain one of the mostly hotly debated issues at the NAIC. Although PBR implementation is uncertain, it is nonetheless clear that the NAIC is intent on addressing, in one form or another, XXX/AXXX reserve financing transactions. It remains to be seen whether the NAIC will embrace the PBR-like approach to such transactions as suggested by the Rector Report or will instead follow New York's lead and revise the current formulae to address reserve redundancies. Interested parties should continue to closely monitor the NAIC's activities in this regard.

III. BRIEFLY NOTED

A. TRIA Update

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. As of the date of this publication, Congress has yet to reauthorize TRIA, although on April 10, 2014 a bipartisan group of U.S. senators announced an agreement on legislation that would prevent the scheduled expiration and extend TRIA for an additional seven years. Significant changes to TRIA under the proposed legislation would include an increase from 15% to 20% of the private insurers' copayment requirement on losses in

excess of the deductible, which increase would be phased in over a five-year period. In addition, the mandatory federal recoupment threshold is proposed to be increased from the current $27.5 billion to $37.5 billion, *i.e.*, when the insurance industry's aggregate uncompensated losses are less than $37.5 billion, the federal government would be required to recoup payments made to insurers under TRIA through policy surcharges.

State regulators and the insurance industry had been vocally calling on Congress to reauthorize TRIA, and thus the announcement of this legislation is likely to be well received in the property and casualty insurance market.

B. Mortgage Guaranty Insurance Update

At the Spring National Meeting, the Mortgage Guaranty Working Group (the "MG Working Group") received and discussed comments to the proposed revisions of the Mortgage Guaranty Insurance Model Act (in this subsection, the "Model"). The MG Working Group had previously prepared a Conceptual Draft of the Model, essentially drafting a new Model that significantly strengthened regulation of the industry (the "Conceptual Draft"). Following the Fall National Meeting, several mortgage guaranty insurers worked together to provide a proposed draft of the Model (the "Industry Draft") which was submitted to the MG Working Group. Commissioner Ted Nickel of Wisconsin, chair of the MG Working Group, observed that, rather than writing a brand-new Model as the MG Working Group had done, the industry had instead taken the approach of improving and modernizing the existing Model. He listed various ways in which measures to strengthen regulation that were included in the Conceptual Draft were weakened in or missing from the Industry Draft. Despite being chastised at the Fall National Meeting by Deputy Insurance Commissioner Johnson for its seeming lack of appreciation for the concessions made by the MG Working Group, the industry has persistently brought its opposing views to the attention of the regulators. Fannie Mae also submitted comments to the Conceptual Draft.

While industry representatives argued that the Industry Draft provisions are suitable and sufficient, it was clear that members of the MG Working Group were not satisfied with the stance of the industry. Deputy Insurance Commissioner Johnson stated at the MG Working Group meeting that there must be stronger requirements for contingency reserves than there had been during the financial crisis of 2008, as the requirements proposed in the Industry Draft would not have ensured enough capital on reserve to sufficiently protect the industry and its policyholders, had such requirements been in place at that time. Commissioner Nickel observed that the FIO has recommended that mortgage guaranty insurance should be overseen by federal regulators rather than state regulators, and stated that since he does not agree with the FIO's position, the MG Working Group needs to continue to make progress by going over the drafts line-by-line and setting up calls and meetings to discuss revisions. The next step will be to continue revisions to the Conceptual Draft in light of some of the comments received.

The MG Working Group also heard an update from NAIC staff on proposed federal legislation that could significantly affect the industry, including the Housing Finance Reform and Taxpayer Protection Act of 2014 (the "2014 Reform Act"). The 2014 Reform Act proposes to wind down Fannie Mae, Freddie Mac and the Federal Housing Finance Agency, while creating an entity to function in a similar fashion to the FDIC that will run a federal mortgage insurance fund offering an

explicit federal guarantee after the market has absorbed a 10% loss. It was noted that related 2013 proposed legislation had wide support, and that the NAIC had provided input to the Senate Banking Committee on it; however, it was stated that the recent 450-page discussion paper shows that the 2014 Reform Act has transformed it into "very different legislation" which addresses a variety of housing issues outside of mortgage guaranty insurance, and in which the White House has become involved.

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

Name	Phone	Email
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	+44 203 580 4704	nbugler@willkie.com
Joseph D. Ferraro	+44 203 580 4707	jferraro@willkie.com
Judith Harger	+44 203 580 4705	jharger@willkie.com
Jon J. Lyman	+44 203 580 4701	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

Name	Phone	Email
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 fax number is (212) 728-8111. Our website is located at www.willkie.com.

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