CLIENT MEMORANDUM

NAIC Report: 2014 Fall National Meeting

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AUTHORS

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

The 2014 Fall National Meeting was held in Washington, D.C. from November 15 to 19, 2014. At this meeting the long-awaited Corporate Governance Model Act and Regulation were adopted by the Executive & Plenary, and progress was made on a number of important initiatives. The work of the committees has continued after the meeting in a rush of intense activity as various groups hustle to complete initiatives by the end of 2014. Projects that are expected to be finalized before year-end include changes to the Model Holding Company Act that would authorize insurance commissioners to act as the group-wide supervisor for internationally active insurance groups, NAIC approval of seven international regulators as “Qualified Jurisdictions” pursuant to the Credit for Reinsurance Model Act, and adoption of Actuarial Guideline 48 in connection with the XXX/AXXX Framework. Finally, news of some notable departures: Commissioner Sandy Praeger of Kansas attended her last NAIC meeting prior to retirement, and Commissioner Tom Leonardi of Connecticut announced shortly afterward that he will be resigning his position to return to the private sector.

This report summarizes some of the key activities at the Fall 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

A. Insurance Holding Company Act Developments

1. State Authority to Serve as Group-Wide Supervisor

2014 has been a very active year for the Group Solvency Issues (E) Working Group (the "GS Working Group"), which has drafted changes (the "HCA Draft") to the NAIC Model Insurance Holding Company Act and Regulation (the "Model HCA") focused primarily on U.S. regulators' authority to lead or participate in the group-wide supervision of certain international insurance groups.

The HCA Draft provides for a state insurance commissioner, in cooperation with other state, federal and international regulators, to determine whether the commissioner is the appropriate group-wide supervisor for an internationally active insurance group ("IAIG") with substantial insurance operations in the state. Factors considered in determining which regulator should assume the role of group-wide supervisor ("GWS") include the domicile of the largest insurers in the IAIG, the domicile of the top-tiered insurer in the group, whether another jurisdiction seeks to act as GWS and whether another U.S. insurance regulator already acts as the "lead state." Following the Fall National Meeting, it was decided on a conference call of the GS Working Group that the HCA Draft should adhere as closely as possible to the "lead state" evaluation process which is already working well in the U.S., and almost all of the "lead state" identification criteria are included as criteria to be considered in determining the GWS. This method was agreed upon after much discussion over whether to consider the domiciles of principal companies in the insurance group before any other criterion. It was also decided on the subsequent conference call that the HCA Draft should include an explicit statement that there can only be one GWS for any group. There has been substantial debate over whether the HCA Draft should grant authority to commissioners to serve as GWS for all international insurance groups ("IIGs"), or to limit the authority to IAIGs, a term which currently mirrors the IAIG concept used by the International Association of Insurance Supervisors (the "IAIS"). While the GS Working Group initially opted for IIGs, after receiving feedback from its parent committee regulators, including Commissioner Michael Consedine of Pennsylvania, the President-Elect of the NAIC, they chose to limit the GWS authority to IAIGs. The GS Working Group and industry have also supported and included the possibility for non-IAIG groups to "opt in" if they want to have their GWS determined or recognized.

In addition, although granting authority over all IIGs is seemingly off the table, there has been a heated debate over whether the HCA Draft should include the authority for commissioners to have discretion to extend their powers to apply to groups that have not been designated as IAIGs. At the Fall National Meeting, the HCA Draft provided for commissioners to use this discretionary authority on groups that "are likely in the near future" to become IAIGs, or which meet some of the criteria for designation as an IAIG. Some members of the industry were troubled that adopting this authority would be tantamount to adopting the Common Framework for the Supervision of Internationally Active Insurance Groups ("ComFrame"), and thought that that question should not be settled in the GS Working Group. With the GS Working Group's goal of completing the Draft HCA by year-end in mind, it was decided at the Fall National Meeting to remove the discretionary language from the HCA Draft and to refer the issue to the ComFrame Development and Analysis (G) Working Group ("CDAWG") for resolution. The CDAWG agreed they would give feedback quickly but the GS Working Group decided not to wait to hear back from CDAWG on this issue. On December 3rd and 4th, the GS Working Group and Financial Condition (E) Committee (the "(E) Committee") adopted the HCA Draft, noting that if feedback is provided by CDAWG later they will have to tend to any changes at that time.

Commissioner Consedine stated that he will be submitting the Draft HCA to the NAIC Executive (EX) Committee (the "Executive Committee") & Plenary for their consideration and adoption on a December conference call, rather than the typical procedure of asking them to consider it at the next National Meeting, in order to get the revisions to the Model HCA finalized by year-end 2014.

2. 2010 Amendments to the Model Insurance Holding Company Act Update

At the meeting of the Financial Regulation Standards and Accreditation (F) Committee (the "Accreditation Committee"), it was noted that 38 jurisdictions have adopted the 2010 amendments (the "2010 Amendments") to the Model HCA. The NAIC maintains a map available here showing the jurisdictions that have adopted the 2010 Amendments. The remaining jurisdictions, which include states such as New Jersey and Michigan per the map, will be required to adopt these revisions by no later than January 1, 2016, since the adoption of the 2010 Amendments to the Model HCA will be required for accreditation purposes as of that date. The NAIC has consistently encouraged states to continue to work aggressively on adopting the 2010 Amendments, notwithstanding the currently proposed additional revisions to the Model HCA described above.

B. Corporate Governance Working Group Completes Its Mission

1. Corporate Governance Model Act Status and Next Steps

At the Summer National Meeting, the Executive & Plenary adopted the final Corporate Governance Annual Disclosure Model Act (the "CG Model Act") and the Corporate Governance Annual Disclosure Model Regulation (the "CG Model Regulation"). The CG Model Act sets forth procedural requirements with respect to a new corporate governance annual disclosure (the "CGAD") and the CG Model Regulation contains the CGAD's disclosure requirements.

The Corporate Governance (E) Working Group (the "CG Working Group") continued its rapid progress at the Fall National Meeting by approving memoranda that recommend to the Accreditation Committee the significant elements for NAIC accreditation with regard to the CG Model Act, the CG Model Regulation and the Annual Financial Reporting Model Rule (commonly referred to as the "Model Audit Rule"). These significant elements for accreditation capture the key components of an insurer's corporate governance framework: (i) the insurer's or insurance group's corporate governance structure; (ii) the policies of the most senior governing entity; (iii) the policies for directing senior management; and (iv) the processes by which the Board of Directors, its committees and senior management ensure appropriate oversight for the insurer's critical risk areas. At the Fall National Meeting, the only discussion was a reiteration of concerns from Florida regulators and industry members regarding the confidentiality language in the CG Model Act, but it was decided that these arguments had been exhausted for the purposes of the CG Working Group review, and that the current language that conforms to typical NAIC Model Act confidentiality language would be approved. It was noted that the issue could be taken up again by the committees that will now review the memoranda. Following the approvals, it was agreed that the CG Working Group would seek permission from the (E) Committee to disband; (E) Committee subsequently granted that permission.

The work of the CG Working Group has been a key component of the NAIC's solvency modernization initiative, and its completion will benefit the United States as its compliance with related international principles is evaluated during the pending Financial Sector Assessment Program ("FSAP") of the United States. It is expected that the CG Model Act requirements will go into effect in 2016 if adopted by the states, with the first corporate governance annual disclosures due on or before June 1, 2016.

C. International Regulation

1. IAIS

The IAIS continues its work on ComFrame and developing international capital standards. The IAIS continues to field test ComFrame, and has recently begun the "qualitative phase" of field testing. Field testing of ComFrame consists of performing impact studies of all the ComFrame elements to see if each "leads to effective group-wide supervision of IAIGs, are of practical and substantive value and do not lead to excessive costs to IAIGs and their supervisory colleges." The qualitative phase of field testing includes studying governance, enterprise risk management, group structure and strategy, and it is expected field testing will demonstrate how risks related to those are managed.

The first tier of the international capital standards, basic capital requirements or "BCR," which will only be applicable to global systemically important insurers ("G-SIIs"), was approved by the IAIS and went to the G-20 for approval in November. The form of the BCR is therefore expected to be finalized by year-end, though not yet effective. The second tier, high loss absorbency or "HLA," also only applicable to G-SIIs, is underway with a consultation paper being drafted and finalization of the form expected in 2015. The third tier, insurance capital standard or "ICS," to be applicable only to IAIGs, will follow with finalization of the form in 2016. It was reported that there is not a clear answer yet on which level of a holding company group the ICS will be applied to – whether it will be applicable to the ultimate parent or instead to an intermediate holding company. The effective date for G-SIIs and/or IAIGs to be subject to the three tiers is expected to be 2019. U.S. regulators expressed relief that a methodology of GAAP with adjustments was being used in field testing, rather than a market-consistent valuation.

Separately, it was reported in connection with the IAIS's work on Financial Stability that they are now considering the concept of total loss absorbent capacity ("TLAC"). TLAC is a concept that the Financial Stability Board has been exploring for assessing and regulating banks, and the IAIS is considering whether it should be applied to G-SIIs.

It was reported on November 6, 2014 that the IAIS determined that the nine G-SIIs designated previously will remain the only designated G-SIIs pursuant to this year's evaluation. Although it had been expected that reinsurer G-SIIs would also be announced this year, that has been postponed in order to further develop the underlying methodology.

2. Discussion of "Team USA" Approach Continues

In the international meetings of the Fall National Meeting, discussion continued on how to craft a unified "Team USA" approach to international regulatory discussions. The main topic at the CDAWG meeting was its draft U.S. Group Capital Methodology Concepts Paper (the "Concepts Paper"), which examines whether to use a risk-based capital ("RBC") based methodology, cash-flow stress testing methodology, or a hybrid approach, to create a risk-based group capital standard for internationally active U.S. insurance groups. The Concepts Paper, which reiterates U.S. regulators' belief that supervision of legal entities takes precedence over group capital needs, explains each method and the associated pros and cons.

The RBC-based methodology would be based on U.S. GAAP accounting (or, if an insurer does not file GAAP statements, then an approximation of a U.S. GAAP balance sheet). The Concepts Paper notes that U.S. GAAP accounting is more acceptable to insurance regulators than reliance on U.S. statutory accounting for this purpose. Additionally, this method would not simply aggregate the RBC calculations of the group's insurance entities, but would rather apply a separate formula to the group's consolidated balance sheet. The result would be a quantifiable measure of group capital that is more easily comparable to an individual entity's capital levels.

The cash-flow stress testing methodology would be an approach to development of RBC that is accounting-independent. This means that the same methodology could be applied to any insurer or group, regardless of whether it conducts its accounting on a U.S. GAAP, non-U.S. GAAP, or other accounting system. Testing would rely on internal models that incorporate regulator-approved parameters and that would be designed to include all risks described in the insurance group's Own Risk and Solvency Assessment documentation. As with asset adequacy testing, internal modeling would calculate cash flows in and out of the group, project them forward, and then subject the projections to various stress scenarios. Unlike the RBC method discussed above, this approach would not easily translate into a quantifiable group capital ratio, and would rely in part on internal models rather than a uniform formula. One of the disadvantages of this approach was noted by Commissioner Consedine, who stated that getting international acceptance of the cash-flow methodology would be a heavy lift. The Concepts Paper also notes that NAIC staff has considered the possibility that a combination of the RBC and cash-flow stress testing approaches may be developed. CDAWG is looking to get input from the Federal Insurance Office ("FIO") and the Federal Reserve Board on this issue.

Team USA will doubtless miss the valuable contributions of a U.S. regulator who has been very publicly involved in these discussions, among others: Commissioner Tom Leonardi, who announced shortly after the Fall National Meeting that he will be stepping down from his position and returning to the private sector. Commissioner Leonardi was notably supportive of the Team USA approach following meetings at the Summer National Meeting, where the Federal Reserve Board indicated its enthusiasm for the approach.

3. Covered Agreement on Reduced Collateral for Reinsurance in the Works

Director Michael McRaith of FIO mentioned in a recent meeting of the Federal Advisory Committee on Insurance ("FACI"), the advisory committee to FIO, that a covered agreement on reduced collateral for reinsurance was being negotiated with an international regulator of an unnamed foreign jurisdiction. At the Fall National Meeting it was confirmed in several meetings that a covered agreement on reduced collateral for reinsurance is being worked on by FIO, the Office of the United States Trade Representative and the White House. Under Dodd-Frank, one of the specific authorities given to FIO is the power to assist the Secretary of the Treasury in negotiating covered agreements with international regulators on behalf of the United States that relate "to the recognition of prudential measures with respect to the business of insurance or reinsurance that achieves a level of protection for insurance or reinsurance consumers that is substantially equivalent to the level of protection achieved under State insurance or reinsurance regulation." It was pointed out that the United States had granted a concession to international reinsurers in allowing the reduced collateral concept to be added to the amended Credit for Reinsurance Model Act (the "Amended Credit for Reinsurance Model Act"), and that now a reciprocal recognition or concession of equal significance should be forthcoming from international regulators that benefited. It was not discussed which jurisdictions the draft covered agreement will be negotiated with. However, we note that earlier this year, the EU-US Insurance Project — which builds on the established U.S.-EU bilateral dialogue and includes representatives from the NAIC, the European Commission, the European Insurance and Occupational Pensions Authority and the FIO — proposed in its roadmap document known as "The Way Forward" that initial steps should be taken toward entering into a covered agreement between the European Union and the U.S. federal government by the end of 2014. The covered agreement would be a step towards achieving the objective of "the further reduction and possible removal of collateral requirements in both jurisdictions in order to ensure a risk-based determination for all reinsurers in relation to credit for reinsurance," and is envisioned in "The Way Forward" to be based on the Amended Credit for Reinsurance Model Act and the amended Credit for Reinsurance Model Regulation. It remains to be seen whether the fact that the reduced collateral concept has not been adopted by all states or required for NAIC accreditation purposes is an issue in negotiating the covered agreement.

4. Joint Forum to Disband

It was confirmed at the International Insurance Relations (G) Committee (the "(G) Committee") meeting that the Joint Forum will be disbanding, most likely in 2015. The Joint Forum is an international group whose parent committees are the Basel Committee on Banking Supervision, the International Organization of Securities Commissions and the IAIS, and which is therefore well-positioned to address cross-sectoral issues. After some joking that the disbandment decision swiftly followed the appointment of Ben Lawsky, Superintendent of the New York State Department of Financial Services ("NY DFS"), to its representative ranks, Commissioner Leonardi, Lawsky and other Committee members criticized the decision to disband, stating that the existence of the Joint Forum provided an important service by offering an ongoing mechanism to address cross-sectoral issues, and that in the future when cross-sectoral issues come up a new mechanism will need to be adopted or body created, which is very inefficient. Commissioner Leonardi also expressed concern about which body had made the decision the Joint Forum would disband. Mr. Yoshi Kawai, Secretary General of the IAIS, responded that the IAIS is still willing to work on cross-sectoral issues and will figure out how to handle workstreams as it becomes necessary. Commissioner Leonardi, at the least, remained unimpressed.

5. IAIS's Step Away From Transparency Still Attracting Criticism

At the Fall National Meeting, regulators and industry continued to speak strongly against the changes to the IAIS's observer and participation rules that will lead to reduced transparency. Mr. Kawai attended some of the international meetings and stated that there will be two IAIS public hearings in the United States where interested parties will be able to speak, currently expected to be held February 6th in Florida and May 6th in New York City.

In a sign of the ongoing tension between the NAIC and FIO, Commissioner Donelon of Louisiana publicly noted his disappointment that FIO did not stand with U.S. state regulators in voting against the change in policy.

6. United States FSAP is Underway

At the (G) Committee meeting it was noted that the FSAP of the United States is well underway. The FSAP is an evaluation conducted every five years by the International Monetary Fund (the "IMF"), which analyzes the strength and scope of an insurance regulatory scheme under the standards of the Insurance Core Principles promulgated by the IAIS. The United States has submitted its self-assessment, and the IMF has made on-site visits to locations including NAIC offices. The IMF is working on finalizing its report, which will be delivered in 2015.

D. Reinsurance Update

1. Amended Credit for Reinsurance Model Act Update

The Reinsurance (E) Task Force (the "Reinsurance Task Force") advised that, as of the Fall National Meeting, the NAIC's Amended Credit for Reinsurance Model Act, which allows for reduced reinsurance collateral requirements for unauthorized reinsurers, has been adopted in 23 states. The Reinsurance Task Force noted that five further jurisdictions (i.e., the District of Columbia, Illinois, Massachusetts, Michigan and Texas) are currently working to adopt the Amended Credit for Reinsurance Model Act. In addition, they advised that over 30 reinsurers have thus far obtained certified reinsurer status, with more waiting to be approved.

2. Seven Qualified Jurisdictions to be Approved

As of the Fall National Meeting, the Qualified Jurisdiction (E) Working Group (the "Qualified Jurisdiction Working Group") had recommended that the NAIC approve five jurisdictions for addition to the NAIC List of Qualified Jurisdictions: Bermuda, Germany, France, Ireland and the United Kingdom. Since the Fall National Meeting, they also recommended two more jurisdictions: Switzerland and Japan. Once a foreign jurisdiction is added to the NAIC List of Qualified Jurisdictions, U.S. states that have adopted the Amended Credit for Reinsurance Model Act can implement reduced collateral requirements with respect to reinsurers domiciled in that jurisdiction.

The Qualified Jurisdiction Working Group expects to conduct a conference call in mid-December to submit all seven of the proposed Qualified Jurisdictions to Executive and Plenary for approval for addition to the NAIC List of Qualified Jurisdictions effective as of January 1, 2015. Absent any unexpected developments specific to a Qualified Jurisdiction, each of the jurisdictions will remain on the NAIC List of Qualified Jurisdictions for a period of five years.

3. Reinsurance Financial Analysis Working Group Continues "Passporting" Work on Certified Reinsurers

The Reinsurance Financial Analysis (E) Working Group (the "Reinsurance-FAWG") reported that it is continuing the development of the uniform application checklist for certified reinsurers. At the industry's request, the Reinsurance-FAWG has made several revisions to the uniform application, including incorporating a "de minimis" rule with respect to overdue reinsurance balances, that now permits an applicant reinsurer to not report any such balances that are not significant enough to meet the thresholds specified in the uniform application. The Reinsurance-FAWG has received over 30 comment letters pertaining to the uniform application, and is continuing its work on revisions in response to these comments. The uniform application checklist is to be utilized by reinsurers certified in one state, which can then apply to Reinsurance-FAWG to be "passported." The "passporting" process is essentially the NAIC's recommendation that other states defer to the original state's conclusion that the reinsurer meets the standards appropriate for certification and collateral reduction.

4. Proposal for Reduced Collateral to Become an Accreditation Standard

During the Reinsurance Task Force's session at the Fall National Meeting, the Reinsurance Association of America ("RAA") urged the Reinsurance Task Force to propose adding the Amended Credit for Reinsurance Model Act to the list of full NAIC accreditation standards. Currently, the Amended Credit for Reinsurance Model Act is an optional accreditation standard—which means that a state can choose whether or not to adopt reduced collateral provisions that are substantially similar to the Amended Credit for Reinsurance Model Act. The RAA representative noted that many states have not taken any steps to adopt reduced collateral provisions to date, which imposes a significant burden upon the reinsurance industry, and that if the NAIC were to add the Amended Credit for Reinsurance Model Act to its accreditation standards the holdout states would be required to adopt laws permitting certified reinsurers to post reduced collateral.

The RAA's efforts to enable reinsurers to post reduced collateral have by no means been limited to the RAA's lobbying efforts at the NAIC. Indeed, the RAA has been working with federal authorities to pursue covered agreements with foreign jurisdictions that would give unauthorized reinsurers a federal mandate to post reduced collateral to support their contracts with U.S. cedents—regardless of any U.S. state law to the contrary. Under Dodd-Frank, the FIO has authority to assist the Secretary of the Treasury to negotiate such covered agreements. In response to the RAA's presentation at the Reinsurance Task Force's session, insurance regulators inquired whether the addition of the Amended Credit for

Reinsurance Model Act to the list of full NAIC accreditation standards would alleviate the need for the RAA to encourage the FIO and the Department of Treasury to enter into covered agreements with foreign jurisdictions. In response, the RAA representative stated that the RAA would continue its work in support of covered agreements regardless of any decision made by the NAIC with respect to accreditation standards.

E. Unexpected Controversy at the Valuation of Securities (E) Task Force Meeting

During the 2013 Fall National Meeting, the NAIC Securities Valuation Office ("SVO") reported that state laws make inaccurate and inconsistent references to NAIC designations and related processes. As such, the Valuation of Securities (E) Task Force (the "Valuation of Securities Task Force") has developed technical guidance to assist states in aligning state law references to NAIC designations and related processes. This initiative is intended to prepare the states for the upcoming NAIC credit assessment framework (*a/k/a* the "Recalibration" project). To that end, the Valuation of Securities Task Force proposed to refer the developed technical guidance to the Accreditation Committee.

Although some members of the Valuation of Securities Task Force stressed that the proposed technical guidance intends to achieve nothing more than uniformity in terminology and would not be binding on states, the proposal unexpectedly sparked a heated discussion with a number of regulators, led by the representative of the Connecticut Insurance Department, openly questioning whether the proposal would, in fact, be binding. As a result, the majority of the Valuation of Securities Task Force's members voiced opposition to the proposal, resulting in the motion to refer the developed guidance to the Accreditation Committee failing by a vote of seven for and nine against.

Separately, the Valuation of Securities Task Force adopted an amendment to the Purposes and Procedures Manual of the SVO to equalize the credit rating standard between foreign and domestic banks. Prior to the adoption of this amendment, a foreign bank was required to maintain a higher rating in order to be added to the SVO bank list than the rating required to be maintained by a comparable U.S. domestic bank.

F. Briefly Noted

1. Cyber Risk Steals the Spotlight

At the Fall National Meeting, the topic du jour was cyber risk, which was addressed in multiple meetings and also had been a major topic of discussion at the November 6th meeting of FACI. The discussions have covered the scope of the threat, the potential consequences of data breaches at insurance companies, and also the increased interest in and difficulty of writing coverage for cyber risk. The Executive Committee set up a new task force, the Cybersecurity (EX) Task Force, which will be tasked with monitoring and facilitating communication about this issue, although at this point it has not been assigned any deliverables such as a white paper or Model guidance.

2. NAIC Internal Governance Review Process Continues

The Governance Review (EX) Task Force (the "GR Task Force") met to continue its work with respect to corporate governance issues at the NAIC. The GR Task Force was formed in response to Commissioner Leonardi's public criticism of the NAIC's corporate governance practices in December 2013. Upon its formation, the GR Task Force was charged with considering whether to engage an outside consultant to review the NAIC's corporate governance documents, practices and procedures. Although a consultant has yet to be engaged, Director John Huff of Missouri reported at the Fall National Meeting that the GR Task Force hopes to complete the initial face-to-face interviews of potential consultants by the end of 2014. In response to a request by interested parties, the GR Task Force meeting also featured a presentation on administrative due process requirements relating to changes to documents drafted by the NAIC.

The GR Task Force expects to continue its work in 2015. However, they will be doing so without the input of Commissioner Leonardi, whose position as a seemingly objective evaluator of the NAIC's corporate governance issues will be sorely missed by public observers.

3. Election of NAIC Officers

The following officers of the NAIC were elected for 2015:

President: Montana State Auditor and Commissioner of Securities and Insurance Monica Lindeen

President-Elect: Pennsylvania Insurance Commissioner Michael Consedine

Vice President: Kentucky Insurance Commissioner Sharon Clark

Secretary-Treasurer: Wisconsin Insurance Commissioner Ted Nickel

We note that Commissioner Consedine joked in several meetings that he hopes to be a part of future NAIC meetings, and was accompanied to some of them by the new governor of Pennsylvania. In Pennsylvania the Commissioner of Insurance is appointed by the governor of Pennsylvania, and so it remains to be seen whether Commissioner Consedine will retain his position under the new governor, and be in place to serve as NAIC President in 2016.

II. TOPICS OF INTEREST TO THE LIFE INSURANCE INDUSTRY

A. Don't Believe What You May Have Heard - XXX/AXXX Framework Still Scheduled for Approval This Year

In a surprising move, the Principle-Based Reserving Implementation (EX) Task Force (the "PBR Implementation Task Force") did not refer Actuarial Guideline 48 ("AG48") to the Executive Committee and Plenary during the Fall National Meeting. AG48 is an important component of the XXX/AXXX Reinsurance Framework (the "Framework"), which is part of the NAIC action plan to develop further regulatory requirements specific to XXX and AXXX transactions. While the NAIC intends to create a new model regulation to curtail the usage of XXX and AXXX transactions, AG48 is meant to be utilized as a stop-gap measure to curtail such transactions on a prospective basis while the new model regulation is developed and adopted by the states—a process that could take several years. AG48 generally requires the opining actuary of the ceding insurer to issue a qualified opinion if the requirements outlined in the Framework are not followed.

It is possible that the delay of the referral of AG48 to the Executive Committee & Plenary was caused in part by the complex interplay of charges of the various NAIC committees related to the Framework. While AG48 was developed by the Life Actuarial (A) Task Force ("LATF") and the PBR Implementation Task Force, the new model regulation governing XXX and AXXX transactions—which will be based in large part on the text of the adopted AG48—will be developed by the Reinsurance Task Force. During previous conference calls of the Reinsurance Task Force, its members expressed a strong desire to be able to review and provide comments to the finalized draft of AG48. During its session at the Fall National Meeting, the Reinsurance Task Force reported that the Reinsurance Task Force and the PBR Implementation Task Force had come to an understanding that, upon final approval of AG48 by the PBR Implementation Task Force, an unofficial "subgroup" of the Reinsurance Task Force would review the approved text of AG48 to determine whether any changes to that text would be required. If so, the Reinsurance Task Force would submit any such changes to the PBR Implementation Task Force. Subsequently, upon the approval of AG48 by the Executive Committee and Plenary, the Reinsurance Task Force would proceed with drafting the new model regulation based on the text of AG48.

Perhaps to set this chain of events in motion, the PBR Implementation Task Force made and subsequently passed a motion to adopt the draft AG48. In connection with this motion, Rhode Island Superintendent of Insurance Joseph Torti III assured all interested parties that, even though AG48 would not be referred to the Executive Committee and Plenary during the Fall National Meeting, any rumors that anyone may have heard about AG48 being delayed past 2014 are untrue. Instead, the PBR Implementation Task Force intends to submit AG48 to the Executive Committee and Plenary during a subsequent call this year, with the intention that AG48 will be approved by the Executive Committee and Plenary before the end of 2014. If approved, AG48 will be in effect as of January 1, 2015.

After the conclusion of Superintendent Torti's remarks, Robert Easton, Deputy Superintendent of NY DFS, delivered a vehement speech opposing the Framework. Mr. Easton stated that for years some regulators had skirted the issue of insurers carrying inadequate reserves due to captive transactions. The Framework, Mr. Easton continued, would not fix this issue, but would instead permit the use of captives to go unabated. The NAIC, Mr. Easton sharply concluded, would come to regret its decision to issue the Framework.

Also voicing his opposition to AG48—albeit for very different reasons—was Mark Birdsall, Chief Actuary at the Kansas Insurance Department, who noted that industry representatives have told him that VM-20, which is a life reserve standard under the Valuation Manual adopted by the NAIC and referenced in the Model Standard Valuation Law ("SVL"), does not reduce reserves to a sufficient level, and that the Framework, which utilizes an actuarial standard that is generally equivalent to VM-20, albeit with certain modifications, would therefore not necessarily fix all XXX/AXXX captive issues. Mr. Birdsall also noted that some captives have been formed based on Actuarial Guideline 43, which provides a principles-based reserving standard for variable annuities, and that the PBR Implementation Task Force may need to run a "Phase 2" in order to discourage the abuse of captives of this type.

In response to these remarks, as well as comments by certain regulators and interested parties in support of the Framework, Superintendent Torti stated that he would be standing alongside Mr. Easton in case the abuse of captives continued after the implementation of Principle-Based Reserving ("PBR"). Superintendent Torti then requested that the PBR Implementation Task Force adopt AG 48. The PBR Implementation Task Force did so, with only New York voting against the proposal.

In a separate development related to the Framework, the Accreditation Committee exposed for a 20-day comment period the proposed Part B accreditation standard relating to the completion of procedures contained within the NAIC Financial Analysis Handbook that pertain to XXX/AXXX transactions.

B. Captive Update – "Multistate Insurer" Definition for Accreditation Moves Forward

The Accreditation Committee has been considering proposed changes to preambles to Part A and Part B of the NAIC Accreditation Program Manual (the "Accreditation Manual") relating to "multi-state reinsurers." The initial draft of these proposed changes previously exposed for comment by the Accreditation Committee would have required every state to subject entities defined as "multi-state reinsurers" (i.e., insurers assuming business that is directly written in more than one state and/or in any states other than the states of their domicile) to the same NAIC accreditation standards as those imposed on traditional insurers. The definition of "multi-state reinsurer" under the previous proposal as described above was sufficiently broad to encompass not only captives assuming XXX/AXXX risks, but also other reinsurers licensed in only one state but assuming risks originating in multiple states.

At the Fall National Meeting, the Accreditation Committee discussed the multitude of comment letters received from interested parties with respect to the proposed definition of "multi-state reinsurer." The majority of these comment letters were in opposition to the potential application of NAIC accreditation standards to "pure" captives, and voiced support for applying NAIC accreditation standards only to captives assuming XXX/AXXX risks. In response to these comments, the Accreditation Committee confirmed that the intention of the proposed revisions to the preambles had never been to apply NAIC accreditation standards to pure captive transactions, and that the initial proposal had been—unintentionally—overly broad. The Accreditation Committee voted to develop revised preambles to Part A and Part B of the Accreditation Manual that would incorporate a revised definition of "multi-state reinsurer" that would encompass only captives assuming XXX/AXXX risks, as well as reinsurance of variable annuities and long-term care reinsurance. The Accreditation Committee intends to expose these proposed revisions for comment before the end of 2014.

C. PBR Update

1. Update on PBR Implementation

The PBR Implementation Task Force advised that, to date, 18 states have adopted the amendments to the SVL, with 12 additional states expected to introduce legislation during 2015. If legislation adopting amendments to the SVL is adopted in these 12 states, the combined total of 30 states that have adopted these amendments will represent 60% of total U.S. premium volume. In order for PBR to be implemented, at least 42 states representing 75% of total U.S. premium volume must adopt these amendments to the SVL. The PBR Implementation Task Force noted that, while a slight chance remains that PBR could become effective as of January 1, 2016, a more realistic PBR effective date is January 1, 2017.

2. Accusations Fly as PBR Implementation Task Force Considers the Small Company Exemption from PBR

The so-called "small company exemption" from PBR, which was originally proposed by The American Council of Life Insurers ("ACLI"), continues to cause controversy at the meetings of the PBR Implementation Task Force. The LATF has now reviewed and revised ACLI's proposal to add, among other items, a suggested premium ceiling of $300 million of ordinary life premiums (or $600 million of ordinary life premiums within the holding company) that an insurer would have to meet to qualify as a "small company," but could not agree on whether the small company exemption should include a footnote to the effect that the PBR Implementation Task Force will review the small company exemption in five years in order to determine whether the small company exemption should be discontinued. While the PBR Implementation Task Force already has general authority to review the small company exemption at any time and therefore does not need a provision expressly permitting the PBR Implementation Task Force to conduct such review in five years, certain members of the PBR Implementation Task Force and the LATF felt that an express provision could serve as a beneficial signaling mechanism for the industry. This issue—which at first glance may appear innocuous—quickly escalated during the meeting of the PBR Implementation Task Force into a heated exchange among representatives of three distinct groups of states, namely: (i) states that want the small company exemption to be implemented temporarily in order to facilitate the transition to PBR for smaller carriers in their states; (ii) states that want a permanent small company exemption; and (iii) states that oppose PBR entirely. Representing the latter group, Mr. Easton of NY DFS delivered a scathing attack on ACLI's proposal, accusing the ACLI of engineering the small company exemption proposal as a politically driven move to encourage further states to adopt PBR. Mr. Easton stated that there is no actuarial basis for the small company exemption, and that the PBR Implementation Task Force should at the very least determine which companies would fall under the exemption prior to rushing headlong into adopting ACLI's proposal. A heated exchange followed, with members of the PBR Implementation Task Force failing to reach an agreement even on issues as fundamental as whether the process of cash flow testing to determine the applicability of PBR would, in fact, prove to be too expensive to undertake for a small carrier. With no conclusion of the debate in sight and time running short, the PBR Implementation Task Force voted to expose the LATF's revised draft small company exemption proposal to a 60-day comment period, with an understanding that the PBR Implementation Task Force would meet internally prior to the expiration of the comment period to discuss the companies to which the exemption would apply. New York voted against this proposal.

D. Briefly Noted

1. Private Equity Working Group Hears from the SEC

The Private Equity Issues (E) Working Group (the "PE Working Group") continues to gather information on issues related to the ownership of insurance companies by private equity firms. At the Fall National Meeting, the PE Working Group heard a presentation by the U.S. Securities and Exchange Commission (the "SEC") on the nature of private equity funds and an analysis of factors that might be considered by insurance regulators reviewing a proposed investment or acquisition, as discussed below. Although Jim Armstrong of the Iowa Insurance Division had been scheduled to discuss the "favored investor" concept, Chair Doug Stolte of Virginia stated that Mr. Armstrong's presentation would not proceed and that draft revisions to the Financial Analysis Handbook, which aim to provide guidance to regulators who are deciding upon "Form A" applications submitted by those seeking to acquire control of an insurer, would not be completed before year-end, and then ended the session early without additional group discussion. He asked for comments to the draft revisions to be submitted by January 15, 2015 so that the PE Working Group can hold a conference call in January, expose the draft for 45 days and receive comments before the 2015 Spring National Meeting.

The SEC's presentation included describing the revenue streams of private equity firms as being (a) management fees, (b) performance fees, (c) ancillary fees and (d) hidden fees. The SEC noted that because such a large percentage of a private equity firm's revenues are from management fees, they can do very well even when the investments are not doing well. The SEC also noted that one way a private equity firm can operate is to buy an insurance company and have it invest in its funds. The SEC described two different strategies that it said can drive private equity firms. Some are growth-based, where the firm invests in a company and stays to build it. Others work on a buy-out strategy, where the value of the company is given to the seller, and then the private equity firm can profit by engaging in financial leveraging techniques such as issuing debt, taking advantage of market changes, and making operational changes such as shutting down a factory.

The SEC stated that a private equity firm can be seen as being 50% a financial services company, but 50% an entrepreneurial enterprise. As a result, the SEC thinks it can be difficult to regulate private equity firms as insurance company owners in a prescriptive way, and suggested that a principles-based approach may be useful. The SEC additionally noted other potential concerns associated with a private equity firm acquiring an insurance company: (a) they would be watchful for poor capitalization of the fund, such as a high level of debt, a significant amount of reinsurance in pools that are not very transparent, a dividend recapture, or high levels of ancillary fees and expenses that drain cash and

(b) they would be concerned about the potential risk for a decline in service quality as the funds overmanage claims and cut personnel. The SEC suggested a regulatory focus on transparency and particular attention to monitoring service levels and complaints as being good strategies for regulators. They also warned that because private equity funds have a typical lifespan of 10 years, it is important for regulators not to permit any type of clawback payment arrangement where another party expects to be able to claw back payments in the future.

On the other hand, the SEC noted that private equity investments in insurance companies could be positive because money flowing into an industry tends to push down prices, because these firms often bring significant experience to the table, and also that insurance companies gain access to investments that are potentially very profitable.

Meanwhile, on November 12, 2014, NY DFS promulgated revisions to New York Insurance Regulation 52 that impose additional requirements on private equity firms that seek to acquire New York insurance companies. Notable changes include the following: (i) the acquirer must additionally submit all plans for the insurer, covering the next five years, to include all plans to declare dividends, to change the insurer's investment portfolio, or make any other material change to the insurer's current business operations or corporate structure, and the insurer cannot deviate from these plans for the next five years without prior written approval of the Superintendent (the "NY Superintendent") of NY DFS; (ii) the acquirer must submit five-year financial projections, and may have to submit new five-year projections at the NY Superintendent's discretion if it seeks to enter into certain new transactions; (iii) if the NY Superintendent determines that the insurer will not have adequate capital, based on the five-year financial projections, the insurer must obtain additional capital that will satisfy the NY Superintendent; (iv) for a life insurer, if the NY Superintendent determines that its acquisition is likely to be hazardous or prejudicial to the insurer's policyholders if a Regulation 114 trust is not set up for their benefit, he may require that one be set up; and (v) background and identity information must also be submitted by the acquirer's general partners, managers and managing members, where applicable. The revisions are effective as of November 12, 2014.

2. Work Continues on Contingent Deferred Annuities Guidance

The Contingent Deferred Annuity (A) Working Group (the "CDA Working Group") is currently developing a regulatory framework for adoption by states with respect to contingent deferred annuities ("CDAs"), including a draft guidance document pertaining to the financial solvency and market conduct regulation of insurers offering CDAs, a framework for nonforfeiture values or cancellation benefits for CDAs, and revisions to clarify the applicability of the Annuity Disclosure Model Regulation, Suitability in Annuity Transactions Model Regulation, Advertisements of Life Insurance and Annuities Model Regulation, and Life Insurance and Annuities Replacement Model Regulation to CDAs.

The draft guidance document pertaining to the financial solvency and market conduct regulation of insurers offering CDAs is under review by the CDA Working Group, and no actions were taken with respect to this guidance document at the Fall National Meeting. The CDA Working Group is looking to the industry to provide more ideas with respect to this guidance. The CDA Working Group intends to expose the latest draft of the guidance document for further comments shortly.

The CDA Working Group adopted draft revisions to the Annuity Disclosure Model Regulation, Suitability in Annuity Transactions Model Regulation, Advertisements of Life Insurance and Annuities Model Regulation, and Life Insurance and Annuities Replacement Model Regulation. During the CDA Working Group's discussion of the draft revisions, a consumer representative noted a number of issues with the proposed drafts and proposed a one-page disclosure template to be given to consumers considering purchasing CDAs. In response, Jim Mumford, First Deputy Commissioner at the Iowa Insurance Division, noted that CDAs are regulated not only by state insurance departments, but also by the SEC, which prohibits disclosures related to CDAs in any materials outside the CDA prospectus. Thus, state insurance departments cannot mandate additional disclosures with respect to CDAs.

III. TOPICS OF INTEREST TO P&C INSURERS

A. Mortgage Guaranty Insurance Model Act Revisions Progressing

The Mortgage Guaranty Insurance (E) Working Group (the "MGI Working Group") continues to discuss and revise the Mortgage Guaranty Insurance Model Act (the "MGI Model") in a process that has continued to be very collaborative with the industry. The MGI Working Group was tasked with determining whether the MGI Model should be updated in the aftermath of the global financial crisis, and now is drafting the revisions. Although the industry initially resisted the level of revision that the MGI Working Group supported, and there has been tension at various points between regulators and the industry regarding the appropriate levels of compromise, they seem to be nearing resolution on many points in the proposed revisions.

At the Fall National Meeting a new version of the proposed revisions to the MGI Model (the "MGI Draft") was reviewed by Commissioner Ted Nickel and Steve Junior of Wisconsin, who described the industry comments accepted, and the industry spoke in support of comments that had not yet been accepted. The accepted changes included a provision allowing investments by mortgage guaranty insurers into securities backed by the full faith and credit of the United States, while changes that have thus far not been incorporated into the MGI Draft included a new record retention provision for mortgage guaranty insurers, a provision making it clear that a multi-line reinsurer may reinsure mortgage guaranty insurance, and a proposal to delete the section relating to rescission relief in light of the unsettled state of the housing market. Mr. Junior noted that they had not had a chance to revise the section of the MGI Draft that covers reinsurance requirements, and heard a number of suggestions for recommended changes. John Finston of California raised the issue that the proposed revisions currently seem to require 100% collateralization of mortgage guaranty, which would conflict with provisions of the Amended Credit for Reinsurance Model Act that potentially permit a reduction of collateral for alien reinsurers that obtain "certified reinsurer" status in a state. Mr. Finston also discussed the importance of making sure that contingency reserves are maintained even when MGI coverage is reinsured by a non-MGI reinsurer, which sparked some conversation. Birny Birnbaum raised the question of whether there has been analysis that supports retaining the 25:1 requirement (i.e., aggregate risk in force shall not exceed 25 times its capital, surplus and contingency reserve) found in the MGI Draft, or whether it has been retained solely as a holdover. MGI Working Group members explained that that requirement was being retained as a backstop to ensure that no company is less stringently regulated under the MGI Draft than by the MGI Model.

The MGI Working Group also briefly discussed the first draft of a Mortgage Guaranty Insurance Standards Manual (the "MGI Manual"), which had been circulated to the group. One of the revisions to the MGI Model has been to add the requirement for the NAIC to promulgate and maintain the MGI Manual, and the group discussed what the scope of the MGI Manual should be, including whether it should incorporate basic descriptions of industry practices and other background material, or whether such material should be separated into a white paper. They will revisit these issues on a conference call.

B. Discussion of Ride-Sharing, Car-Sharing and Home-Sharing Continues

At the Summer National Meeting, the insurance issues surrounding ride-sharing, car-sharing, home-sharing, and similar practices were another hot topic, and the Property and Casualty Insurance (C) Committee agreed to form a new Sharing Economy (C) Working Group (the "Sharing Economy Working Group") to consider them, with Commissioner Dave Jones of California chairing. At its first meeting, the Sharing Economy Working Group discussed their proposed charges, including the task of preparing a white paper on issues related to transportation network companies ("TNCs") like Lyft and Uber, and heard several presentations. The Insurance Services Office ("ISO") presented on some of the ways that traditional home and auto personal lines coverages are being re-purposed by insureds who are using those homes and autos for commercial purposes, but who also may not understand whether their insurance covers the commercial uses. ISO also set out some of the issues that must be considered when writing new policy forms that either cover or exclude coverage for the various commercial practices. Commissioner Jones gave a presentation on his Department's analysis of these issues when considering recommendations to California legislators on their draft legislation increasing liability insurance requirements for those providing ride-sharing services. Commissioner Jones shared some of the recommendations that the legislators took, and some that they did not take in passing AB 2293 to be adopted in September 2014. Additionally, the Sharing Economy Working Group heard a presentation by PCI on some of the ways that insurance issues are presenting challenges for TNCs. A representative of Uber attended the meeting, offering Uber's assistance to the group, an offer that was warmly accepted by Commissioner Jones.

C. Congress Playing Chicken over the TRIA Deadline; TRIA Working Group Prepared to Act

During its meeting, the Terrorism Risk Insurance Implementation (C) Working Group (the "TRIA Working Group") heard an update concerning federal legislative developments with respect to the reauthorization of the Terrorism Risk Insurance Act ("TRIA"), which is due to expire on December 31, 2014. The NAIC continues to strongly support the view that some version of TRIA should be reenacted as soon as possible, and sent a letter to the U.S. House of Representatives on September 9, 2014 supporting a long-term reauthorization of TRIA.

While the U.S. Senate passed a seven-year TRIA reauthorization bill by a vote of 93–4 in July, no bill has yet been passed in the U.S. House of Representatives, which is considering a seven-year reauthorization as well as a shorter-term reauthorization of five years. It was reported to the TRIA Working Group that there is also the possibility of a much shorter reauthorization of six months or one year. We understand that partisan tensions are playing a significant role in the delay. If the House passes a bill, the differences between the House and Senate versions will need to be reconciled before Congress could give its final approval.

In the meantime, in anticipation of a reauthorization, the TRIA Working Group is closely monitoring the situation and preparing to update its model bulletin and expedited filing form, which are intended to help state insurance regulators advise insurers about regulatory requirements related to providing terrorism insurance under TRIA. If Congress passes and the President signs any legislation, the TRIA Working Group will hold conference calls in December in order to finalize those items quickly.

D. Developments in Catastrophe Insurance

At the Fall National Meeting, the Catastrophe Insurance (C) Working Group and the Valuation of Securities Task Force both heard a presentation from an interested party, which argued for special treatment of catastrophe bonds for RBC purposes. The current treatment of catastrophe bonds for these purposes is generally similar to the treatment for the same purposes of other corporate obligations. The interested party noted that this approach does not necessarily make sense, given the special risk profile of catastrophe bonds. While returns on corporate obligations may be affected by economic cycles, the returns on catastrophe bonds are largely uncorrelated with developments in the global economy. Thus, the insurance industry—including both property/casualty and life insurers—would benefit from diversification if investment by insurers into catastrophe bonds were encouraged via a different RBC treatment for such bonds. A greater market for catastrophe bonds would, in turn, prove beneficial for insurers wishing to raise capital by issuing such bonds.

It is by no means certain what interest, if any, this presentation will generate at the NAIC. For now, the presentation has been exposed for comment by the Valuation of Securities Task Force.

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
Rajab S. Abbassi	212-728-8522	rabbassi@willkie.com
Gregory B. Astrachan	212-728-8608	gastrachan@willkie.com
Scott D. Avitabile	212-728-8279	savitabile@willkie.com

Name	Phone	Email
Elizabeth B. Bannigan	212-728-8135	ebannigan@willkie.com
Serge Benchetrit	212-728-8798	sbenchetrit@willkie.com
David K. Boston	212-728-8625	dboston@willkie.com
Thomas M. Cerabino	212-728-8208	tcerabino@willkie.com
Henry M. Cohn	212-728-8209	hcohn@willkie.com
Laura L. Delanoy	212-728-8662	ldelanoy@willkie.com
Alexander M. Dye	212-728-8642	adye@willkie.com
Mark Getachew	212-728-8647	mgetachew@willkie.com
William H. Gump	212-728-8285	wgump@willkie.com
Jeffrey Hochman	212-728-8592	jhochman@willkie.com
Arthur J. Lynch	212-728-8225	alynch@willkie.com
Leslie M. Mazza	212-728-8245	lmazza@willkie.com
Vladimir Nicenko	212-728-8273	vnicenko@willkie.com
Benjamin Nixon	212-728-8532	bnixon@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

Name	Phone	Email
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
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, Houston, Paris, London, Frankfurt, Brussels, Milan and Rome. 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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