

NAIC HIGHLIGHTS – SPRING 2008 NATIONAL MEETING**The NAIC**

The National Association of Insurance Commissioners (the “NAIC”) works to coordinate the efforts of the insurance commissioners of the U.S. states and territories and the District of Columbia (including promulgating model laws and regulations). The NAIC held its Spring National Meeting from March 29th through March 31st in Orlando, Florida. At this meeting, many important issues were discussed by the various NAIC committees, task forces and working groups. Set forth below are certain highlights of the meeting.

Reinsurance Regulatory Modernization Framework

The NAIC adopted the reinsurance regulatory modernization framework (the “Framework”) to reform reinsurance regulation for both domestic and foreign reinsurers. In 2006, the NAIC charged its Reinsurance Task Force with the development of alternatives to the current reinsurance regulatory system. This charge was prompted by changes in the global reinsurance marketplace and in the international regulation of reinsurance, including increased cross-border reinsurance transactions, the development of international accounting standards that incorporate increased transparency, and regional regulatory harmonization efforts such as the European Union (the “EU”) Reinsurance Directive. The Reinsurance Task Force was instructed to consult with international regulators and other interested parties in developing a proposal. The result was the Framework — an ambitious attempt to address issues arising from the multistate regulation of reinsurance and the collateralization requirements currently imposed on foreign reinsurers.

The Framework sets forth three main principles:

1. the creation of an NAIC department to be called the Reinsurance Supervision Review Department (the “RSRD”), which would be charged with assessing the regulatory effectiveness of U.S. and non-U.S. jurisdictions;
2. for each U.S. reinsurer, the creation of a single U.S. state regulator that is certified by the RSRD; and
3. for each non-U.S. reinsurer from an RSRD-approved jurisdiction, the designation of a single U.S. regulator or “port of entry.”

With respect to the single-state regulation of foreign reinsurers, the Framework contemplates the development of “mutual recognition” agreements between state insurance regulators and non-U.S. jurisdictions.

In addition to outlining a new approach to reinsurance regulation, the Framework also lists various outstanding issues, including:

1. establishing appropriate collateral levels, from zero to 100%, for both U.S. and non-U.S. reinsurers;
2. developing mechanisms to ensure uniformity among the states, addressing the level of regulatory authority retained by the ceding insurer's domestic regulator and identifying standards under which a state may qualify for, and maintain status as, a recognized port of entry for non-U.S. reinsurers or as a single-state regulator for U.S. reinsurers; and
3. developing criteria to determine the regulatory equivalence of non-U.S. jurisdictions and establishing how mutual recognition agreements should be negotiated, enforced and terminated.

In furtherance of the Framework, during the Spring National Meeting the Reinsurance Task Force introduced a single-state regulatory framework for "national reinsurers." A national reinsurer would be certified by its state of domicile, or home state, which would itself have been approved as a "certified reinsurance supervisor" by the RSRD. A subgroup comprised of commissioners from New York, Texas, Delaware, Florida, California and Virginia was formed to evaluate criteria for certified reinsurance supervisors.

Under the proposal, the ceding insurer's domestic U.S. jurisdiction would retain its authority under existing law to evaluate the transfer of risk and the amount of liability ceded. Uniform mandatory reinsurance agreement provisions established through the RSRD are also an element of the proposal.

The Reinsurance Task Force is evaluating legal issues presented by the Framework's approach to foreign reinsurers as identified in a legal memorandum prepared for an interested party, which included the following areas of concern: (i) unequal treatment of foreign reinsurers, based on nationality, which would be inconsistent with traditional principles of jurisdictional equivalence; (ii) unconstitutionality of the RSRD's mutual recognition framework because states cannot enter into mutual recognition agreements with foreign powers; and (iii) impracticability of the Framework because it would require unanimous adoption by the states, which is an unrealistic expectation.

Future meetings will address the port of entry concept, collateral calibration issues, required modifications to existing state statutes, accounting guidance and other outstanding issues.

Federal Initiatives

Although the U.S. federal government typically does not directly regulate the business of insurance, federal initiatives could have a significant impact on the insurance industry. Some critics of the current state-based insurance regulatory system have argued that it is unduly burdensome on U.S. and non-U.S. insurers that wish to do insurance or reinsurance business in the U.S. on a national level.

U.S. Treasury Department Proposal for Federal Regulation of Insurance

On March 31, 2008, the U.S. Department of the Treasury released a blueprint for a modernized federal structure for oversight and regulation of all financial services, including insurance.¹ The blueprint includes a proposal for an optional federal charter (the “OFC”) to streamline insurance regulatory requirements for industry participants doing business on a national basis. The OFC would provide a voluntary system for the federal chartering, licensing, regulation and supervision of insurers, reinsurers and insurance producers (including agents and brokers). Industry participants opting into the OFC system would be subject to federal regulation by a new Office of National Insurance within the Treasury Department in lieu of state-based insurance regulation. However, those opting into the OFC system would still be required to comply with other state laws (e.g., state tax laws, compulsory coverage for workers’ compensation and auto insurance, mandatory state residual risk mechanisms and guarantee funds). The current state-based regulatory system would continue to apply to industry participants that do not opt into the OFC system. However, recognizing that the OFC debate has been continuing for some time in Congress, the Treasury Department proposed a short-term solution as well. Specifically, it proposed that a national Office of Insurance Oversight (the “OIO”) be formed within the Treasury Department to address certain insurance regulatory issues that require immediate attention (including international regulatory issues such as reinsurance collateral). Then, if and when Congress passes the more comprehensive proposed insurance regulatory reforms, the OIO could be incorporated into the OFC framework.

NAIC President and Kansas Insurance Commissioner Sandy Praeger immediately responded to the Treasury Department’s blueprint in an NAIC press release² and an interview on CNBC (both on March 31st). President Praeger noted that better coordination and communication among federal and state regulators are essential to effective oversight of the financial services sector. Although she agreed that the federal government needs to modernize its financial regulation, she stressed that the state-based insurance system should be left alone. President Praeger emphasized that (a) consumers depend on their state regulators, (b) the Treasury Department’s plan fails to address the roots of current problems and is needlessly complex and (c) there is no need for a national plan for insurance regulation. In sum, she noted that “[w]hile [the NAIC] welcome[s] a review of the federal failures, [the NAIC] strongly caution[s] against federal intervention in a state-based system that is working for consumers and the industry alike.”³

The Nonadmitted and Reinsurance Reform Act of 2007

On March 28, 2008, the Reinsurance Task Force briefly discussed S.B. 929, entitled the “Nonadmitted and Reinsurance Reform Act of 2007” (the “NRRA”), which is a bill to streamline

¹ The Department of the Treasury, *Blueprint for a Modernized Financial Regulatory Structure* (March 2008), available at <http://www.treas.gov/press/releases/reports/Blueprint.pdf>.

² News Release, “NAIC Response to Treasury Report” (March 31, 2008), available at http://www.naic.org/Releases/2008_docs/praeager_response_treasury_report.htm.

³ *Id.*

the regulation of nonadmitted insurance, surplus lines insurance and reinsurance by setting forth certain federal standards and certain limits on state regulations. S.B. 929 was introduced in the Senate on March 20, 2007 and referred to the Senate Committee on Banking, Housing, and Urban Affairs. The House of Representatives version of the NRRA, H.R. 1065, was adopted by the House on June 25, 2007 and referred to the same Senate Committee. If either bill is enacted in its current form, the NRRA would (i) grant sole regulatory authority with respect to the placement of nonadmitted insurance to the policyholder's home state; (ii) limit states to uniform standards for surplus lines eligibility in conformity with the NAIC Nonadmitted Insurance Model Act; (iii) establish a streamlined insurance procurement process for exempt commercial purchasers by eliminating the requirement that brokers conduct a due diligence search to determine whether the insurance is available from admitted insurers; and (iv) establish the domicile state of the ceding insurer as the sole regulatory authority with respect to credit for reinsurance. Although the Reinsurance Task Force acknowledged that S.B. 929 addresses certain of the task force's concerns, it emphasized the need for a comprehensive approach to modernizing the regulation of reinsurance in lieu of piecemeal legislation.

International Issues

Solvency II

Certain insurers and reinsurers do business internationally, and the NAIC has been making efforts to harmonize U.S. and international standards to facilitate cross-border business (e.g., the reinsurance regulatory modernization framework discussed above). Accordingly, the NAIC's International Insurance Relations Committee has been keeping track of the European Commission's continuing development of Solvency II. The committee's mission is "to strengthen the international insurance regulatory system and provide a forum for cooperative efforts between the NAIC, international regulators and multinational associations of regulators on issues of mutual interest."⁴

Both the U.S. and EU systems are developing principles-based approaches to incorporate into their regulatory systems (either in addition to, or in lieu of, certain rules-based regulations). However, there are some significant differences between Solvency II, as currently being developed, and the current U.S. state-based system, including: (a) the accounting systems recognized, (b) the applicable capital requirements for insurer solvency and (c) the regulation of entire company groups under Solvency II, as opposed to U.S. state regulation of insurance companies only.

Currently, U.S. insurer solvency is governed by codified statutory accounting principles developed by the NAIC. By comparison, Solvency II is expected to adopt international accounting standards similar to those used by the International Accounting Standards Board (the "IASB"). Recently, there has been a significant move toward recognition of international accounting standards, with the U.S. Securities and Exchange Commission accepting IASB accounting for foreign private issuers without the need for a reconciliation to U.S. GAAP. The NAIC is thus considering whether U.S. insurance regulators also should recognize international accounting standards.

⁴ Mission, International Insurance Relations (G) Committee, http://www.naic.org/committees_g.htm.

Solvency II allows the use of full internal company models to determine capital requirements and a group supervisory system (including allowing guarantees by noninsurer parent companies to bolster insurer solvency, thus requiring only minimal capital to be kept at the insurance company level). By comparison, the current U.S. insurance regulatory system governs only the insurance company members of an insurance holding company system and determines insurer solvency based on the capital held by the insurer itself (and closely scrutinizes transactions that would transfer assets from an insurer to another member of its insurance holding company system).

The Solvency II framework is currently at a high concept level, but is expected to be finalized and adopted in 2009 or 2010, with implementation in 2012. At its March 30, 2008 meeting, the International Insurance Relations Committee asked the NAIC staff to develop a work plan dividing Solvency II into sections so that experts can be assigned to monitor Solvency II as it continues to progress and as implementing legislation is developed, thus enabling the NAIC to better anticipate how Solvency II will affect the U.S. insurance industry.

The IAIS and Mutual Recognition of Reinsurance Supervision

The International Association of Insurance Supervisors (the “IAIS”) continues to develop its draft “Guidance Paper on the Mutual Recognition of Reinsurance Supervision,” which is intended to facilitate cross-border reinsurance by allowing jurisdictions to recognize other jurisdictions where regulation and supervision is equivalent, comparable or otherwise acceptable. The IAIS continues to discuss the issue of mutual recognition agreements between jurisdictions, as well as unilateral, bilateral and multilateral recognition by jurisdictions. The guidance paper is expected to be completed in the fall of 2008.

Restructuring Mechanisms for Troubled Companies

On March 28, 2008, the Restructuring Mechanisms for Troubled Companies Subgroup of the Financial Condition Committee (the “Subgroup”) met. The Subgroup’s charge is to (i) undertake a study of solvent schemes of arrangement and Part VII Portfolio transfers (transfers leaving no recourse to the original contractual obligors/insurers) employed in non-U.S. jurisdictions in order to evaluate their potential effect on claims of domestic insureds and on the solvency of U.S. insurers and (ii) consider best practices for U.S. insurance regulators to the extent they employ solvent schemes of arrangement or interact with foreign regulators who have implemented such schemes.⁵

The Subgroup received comments from policyholders, insurance associations and regulators. Generally, these groups have raised objections to foreign schemes of arrangement that require insureds and reinsurers to abide by a claims bar date and to estimate the value of incurred but not reported claims.

⁵ 2008 Charges, Restructuring Mechanisms for Troubled Companies Subgroup, http://www.naic.org/committees_e_restructuring.htm.

With respect to the evaluation of strategies available to U.S. insurance departments, regulators and interested parties generally supported court-supervised run-off of insolvent insurers. However, the Subgroup focused on determining the appropriate treatment of “troubled companies” that are not statutorily insolvent, and decided to evaluate mechanisms that should be made available to regulators to manage the run-off of such insurers. For example, the Subgroup discussed whether current insurance receivership statutes, which include rehabilitation authority, provide regulators with the options and flexibility necessary to address the issues presented by troubled companies. Potential options mentioned during the meeting included privately managed, but state supervised, run-offs; legislation that would more closely follow the U.S. Bankruptcy Code; and the development of run-off schemes based on the characteristics of the U.S. insurer (e.g., different run-off schemes for reinsurers than for primary personal/commercial lines insurers).

The Subgroup will gather information on the types of mechanisms currently available to state insurance regulators with respect to troubled company run-off operations and prepare a white paper for NAIC consideration.

Climate/Catastrophe Issues

On March 29, 2008, the Catastrophe Insurance Working Group considered adoption of the draft white paper entitled “Natural Catastrophe Risk: Creating a Comprehensive National Plan,” but deferred a vote on adoption of the white paper until June. Among other issues, the white paper discusses (a) enhancing insurance contracts so that policyholders better understand their coverage and its limitations (including the possibility of “all perils” policies and natural disaster coverage), (b) developing a comprehensive mitigation program (e.g., financial incentives to encourage policyholders to retrofit their homes to protect against catastrophic events) and (c) state and national catastrophe funds. The working group asked the NAIC staff to update the references contained in the draft, and plans to circulate the updated draft for comments and hold a hearing prior to the Summer National Meeting to work out any additional drafting issues and prepare a final draft for adoption at the summer meeting.

On March 30, 2008, the Climate Change and Global Warming Task Force (the “Climate Task Force”) exposed the Climate Risk Disclosure Proposal for additional written comments to be received by April 15, 2008. The proposal includes certain regulatory interrogatories regarding an insurer’s assessment of, and response to, the effects of climate change. Each insurer would need to respond to such interrogatories in connection with its statutory financial statements. The Climate Task Force heard panel discussions from industry associations on the draft disclosure proposal. The topics discussed included, among others: (a) the confidential proprietary information that would be required to be disclosed, (b) whether the disclosures would lead to increased litigation risks for insurers, (c) whether the interrogatories are intended to gather information or cause insurers to change their practices, (d) the inadequacy of current voluntary disclosures regarding whether and how insurers are addressing climate change (e.g., in insurers’ public filings) and (e) whether the appropriate place for such disclosures is in the annual statement interrogatories or elsewhere (e.g., in the Management Discussion and Analysis (MD&A) disclosures).

The Climate Task Force also exposed the white paper entitled “The Potential Impact of Climate Change on Insurance Regulation” for comments to be received by April 30, 2008. Among other issues, this white paper discusses the implications of climate change on insurer solvency (including insurer investments), insurer exposures to catastrophes and small weather extremes, loss prevention and mitigation issues and disclosure requirements regarding insurer responses to climate risks.

On March 31, 2008, the Plenary Committee adopted the NAIC Disaster Reporting Framework, which is intended to provide advisory, nonbinding (and not all-inclusive) guidance to state regulators regarding procedures for coordinated disaster reporting efforts. Among other things, the framework sets forth procedures for (a) disaster reporting, (b) communication among insurers, state and federal regulators, and interested parties, (c) data collection systems and (d) possible NAIC assistance to a coordinated effort by regulators.

Upcoming NAIC Activities

The NAIC’s Summer 2008 National Meeting will be held in San Francisco, California, from May 31, 2008 through June 2, 2008. In the meantime, the NAIC’s committees, task forces and working groups continue to work on the above and other issues faced by state insurance commissioners, including through interim meetings and conference calls. The NAIC’s calendar of upcoming meetings and events is available at http://www.naic.org/meetings_calendar.htm.

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If you have any questions regarding this memorandum, please contact Leah Campbell (212-728-8217, lcampbell@willkie.com) or the attorney with whom you regularly work.

This memorandum was authored by Leah Campbell and Marshal Bozzo.

Willkie Farr & Gallagher LLP is headquartered at 787 Seventh Avenue, New York, NY 10019-6099. Our telephone number is (212) 728-8000 and our facsimile number is (212) 728-8111. Our website is located at www.willkie.com.

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