

**NAIC HIGHLIGHTS — FALL 2009 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 by promulgating model laws and regulations and encouraging adoption thereof by legislators and regulators). The NAIC held its Fall 2009 National Meeting from September 21 through September 24, 2009 in National Harbor, Maryland. 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 Issues**

The Government Relations Leadership Council and the Reinsurance (E) Task Force discussed several matters during their meetings on September 23 and 24, respectively, including the Reinsurance Regulatory Modernization Act of 2009 and reinsurance-related issues currently before Congress.

***Reinsurance Regulatory Modernization Framework Proposal***

As discussed in previous NAIC Highlights, the NAIC adopted the Reinsurance Regulatory Modernization Framework Proposal (the “Framework”) during its Winter 2008 National Meeting to reform state reinsurance regulation for both domestic and foreign reinsurers electing to participate.<sup>1</sup> The Framework is part of the larger NAIC Solvency Modernization Initiative.<sup>2</sup> As a first step toward implementation of the Framework, on March 24, 2009 the Reinsurance Task Force exposed

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<sup>1</sup> NAIC Highlights - Summer 2009 National Meeting (June 25, 2009) 1-3, available at [http://www.willkie.com/files/tbl\\_s29Publications/FileUpload5686/3015/NAIC\\_Highlights\\_Summer\\_2009\\_Meeting.pdf](http://www.willkie.com/files/tbl_s29Publications/FileUpload5686/3015/NAIC_Highlights_Summer_2009_Meeting.pdf); see also NAIC Highlights - Spring 2009 National Meeting (March 15, 2009) 1-3 (describing the Framework in further detail), available at [http://www.willkie.com/files/tbl\\_s29Publications/FileUpload5686/2932/NAIC\\_Highlights\\_Spring\\_2009\\_Meeting.pdf](http://www.willkie.com/files/tbl_s29Publications/FileUpload5686/2932/NAIC_Highlights_Spring_2009_Meeting.pdf); see also NAIC Highlights - Winter 2008 National Meeting (Dec. 19, 2008) 1-2, available at [http://www.willkie.com/files/tbl\\_s29Publications/FileUpload5686/2826/NAIC\\_Highlights\\_Winter\\_2008\\_National\\_Meeting.pdf](http://www.willkie.com/files/tbl_s29Publications/FileUpload5686/2826/NAIC_Highlights_Winter_2008_National_Meeting.pdf); NAIC Highlights - Fall 2008 National Meeting (Oct. 3, 2008) 3-7, available at [http://www.willkie.com/files/tbl\\_s29Publications/FileUpload5686/2718/NAIC\\_Highlights\\_Fall\\_2008\\_National\\_Meeting.pdf](http://www.willkie.com/files/tbl_s29Publications/FileUpload5686/2718/NAIC_Highlights_Fall_2008_National_Meeting.pdf); NAIC Highlights - Summer 2008 National Meeting (June 12, 2008) 1-3, available at [http://www.willkie.com/files/tbl\\_s29Publications/FileUpload5686/2616/NAIC\\_Summer\\_2008.pdf](http://www.willkie.com/files/tbl_s29Publications/FileUpload5686/2616/NAIC_Summer_2008.pdf); NAIC Highlights - Spring 2008 National Meeting (April 8, 2008) 1-2, available at [http://www.willkie.com/files/tbl\\_s29Publications/FileUpload5686/2582/NAIC\\_Spring\\_2008.pdf](http://www.willkie.com/files/tbl_s29Publications/FileUpload5686/2582/NAIC_Spring_2008.pdf).

<sup>2</sup> The Solvency Modernization Initiative is coordinated by the Solvency Modernization Initiative (EX) Task Force, which oversees the work of five NAIC groups focusing on capital requirements, international accounting, group supervision, valuation issues in insurance, and reinsurance. A summary of SMI activities can be found at [http://www.naic.org/committees\\_ex\\_isff.htm](http://www.naic.org/committees_ex_isff.htm).

a draft federal bill entitled the “Reinsurance Regulatory Modernization Act of 2009” (the “RRMA”) for comments through April 23, 2009.<sup>3</sup>

Since the exposure of the RRMA, interested parties have questioned the constitutionality of the proposed Congressional authorization of the Reinsurance Supervisory Review Board (the “RSR Board”) contemplated under the RRMA on the following grounds: the Appointments Clause (U.S. Const. art. II, § 2, cl. 2), which authorizes the President to appoint all officers of the United States with the advice and consent of the Senate (several interested parties have argued that Congressional authorization of the RSR Board, a private entity acting as a public official without federal oversight, violates the Appointments Clause); the Tenth Amendment to the U.S. Constitution and Supreme Court decisions holding that Congress is not authorized to command state action; the Fifth and Fourteenth Amendments to the Constitution, which guarantee due process for actions of federal and state governments (interested parties have expressed concern that the RRMA does not provide for judicial review of the decisions of the RSR Board); and whether it would be constitutional for states to enter into agreements with foreign jurisdictions as contemplated under the RRMA. In response to such questions, the Reinsurance Task Force has retained the services of Sidley Austin, LLP to review the constitutional issues and propose any necessary revisions.

Since the Summer 2009 National Meeting, the RRMA was exposed for additional comments and has undergone two rounds of revisions. The Reinsurance Task Force held an interim meeting via telephone conference on September 15, 2009 to discuss the latest draft of the RRMA dated September 3, which incorporated changes to address the constitutional issues based on the advice of Sidley Austin. With respect to the Appointments Clause issue, Sidley Austin stated that it is lawful for the RRMA to permit the NAIC to make recommendations to the President for members of the RSR Board because such recommendations are subject to confirmation by the Senate and are not binding on the President. Also, as revised, the RSR Board would be an instrumentality of the federal government, a free standing federal agency similar to the Securities Exchange Commission (the “SEC”) or the Commodity Futures Trading Commission, and there is no constitutional requirement that such agency exist within a larger cabinet department. As a federal agency, the RSR Board would be subject to judicial review by the federal courts and to the requirements of the federal Administrative Procedures Act. Further, Sidley Austin advised that while the types of agreements that individual states would enter into with foreign nations as contemplated under the RRMA are not the types that would require congressional consent, the RRMA constitutes such congressional consent, and the agreements contemplated under the RRMA do not require other states to abide by any such agreements.

At the September 15 interim meeting, the Reinsurance Task Force adopted a motion to adopt the RRMA (with a recommendation for a non-substantive clarification) and to present the RRMA to the Government Relations Leadership Council for its review and consideration of the submission of the RRMA to Congress. During its September 23 meeting, the Government Relations Leadership Council approved the submission of the RRMA to Congress. Because the RRMA is part of the Framework, which was adopted at a joint meeting of the Executive (EX) Committee and Plenary,

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<sup>3</sup> The draft RRMA is *available at* [http://naic.org/documents/committees\\_e\\_reinsurance\\_090915\\_reins\\_ref\\_modernization\\_act.pdf](http://naic.org/documents/committees_e_reinsurance_090915_reins_ref_modernization_act.pdf).

and the submission of the RRMA to Congress for federal implementation would be in furtherance of the Framework, such submission did not require another Executive/Plenary approval. The NAIC is seeking congressional sponsors of the RRMA.

Opposition to the RRMA continues from certain industry trade groups, particularly with respect to (i) what is characterized as inadequate collateral standards for unauthorized alien insurers and reinsurers that participate in solvent schemes of arrangement or similar procedures, and (ii) the RRMA's failure to establish a unified national regulatory voice with respect to reinsurance while the insurance industry is moving towards more cross-border regulatory harmonization, and such oppositions have not been quelled.

### ***Congressional Initiatives Affecting Reinsurance***

During its September 24, 2009 meeting, the Reinsurance Task Force received a report from the NAIC Government Relations Policy Analyst regarding federal legislation affecting reinsurance. The Nonadmitted and Reinsurance Reform Act of 2009 (H.R. 2571) (the "NRRA"), which was introduced by Representative Dennis Moore (D-Kansas) into the House of Representatives on May 21, 2009,<sup>4</sup> was passed by the House on September 9, 2009. A companion bill sponsored by Senators Bayh and Nelson was introduced in the Senate on June 25, and is awaiting committee assignment; however, no hearings are yet scheduled in the Senate. The NRRA generally preempts the application of a non-domiciliary state's laws to reinsurance agreements, and Title II of the NRRA prohibits the extraterritorial application of credit for reinsurance and other kinds of reinsurance requirements by any state other than the ceding insurer's domiciliary state.<sup>5</sup> Similar legislation had been introduced in Congress every year since 2006. Such legislation was passed in the House in 2006 and 2007 but was not picked up by the Senate in either of those years; in 2008, the legislation failed to be voted on in the House.

The Neal Bill, H.R. 3424, which would amend the Internal Revenue Code to disallow the deduction for certain non-taxed reinsurance premiums paid by U.S. property and casualty insurance companies to their offshore affiliates, was introduced on July 20, 2009. There is currently no companion legislation in the Senate and no activity surrounding the bill; however, the NAIC reported that this measure could always be added on to one of the broader reform measures working through Congress.

### ***Reinsurance Accounting***

During its September 22, 2009 meeting, the Accounting Practices and Procedures (E) Task Force adopted Issue Paper No. 137 - Transfer of Property and Casualty Reinsurance Agreements in Run-Off, which would expand the exceptions to retroactive accounting treatment to include certain property and casualty reinsurance run-off agreements. During the Summer 2009 National Meeting, the Statutory Accounting Principles Working Group had exposed revisions to Issue Paper No. 137

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<sup>4</sup> The text of the NRRA is available at [http://thomas.loc.gov/home/gpoxmlc111/h2571\\_ih.xml](http://thomas.loc.gov/home/gpoxmlc111/h2571_ih.xml).

<sup>5</sup> See NAIC Highlights - Summer 2009 National Meeting at 4 (describing the NRRA in further detail).

and SSAP No. 62R - Property and Casualty Reinsurance (Revised). At the Fall 2009 National Meeting, the Task Force decided to re-expose SSAP No. 62R with appropriate changes.

### **Solvency Modernization Initiative**

In June of 2008, the NAIC adopted a long-term work plan for its Solvency Modernization Initiative (the “SMI”). The mandate of the SMI is to produce one cohesive document that articulates the U.S. solvency framework and expresses the foundational principles of the U.S. insurance regulatory system. The compiled principles articulated in the SMI work product are intended to facilitate dialogues with foreign insurance regulators and reconcile U.S. solvency principles with the solvency schemes of foreign jurisdictions. The consolidated principles should also serve as a foundation for the establishment of regulatory priorities and long-term modernization plans. The SMI comprises five key focus areas:

Capital Requirements. This component of SMI includes assessing the appropriateness of current Risk-Based Capital (“RBC”) levels and determining whether to require reporting of an insurer’s economic capital level.

International Accounting. Statutory Accounting Principles (“SAP”) are based on U.S. generally accepted accounting principles (“GAAP”) as established by the U.S. Financial Accounting Standards Board (“FASB”). For insurance accounting, FASB entered into a joint project with the International Accounting Standards Board to establish International Financial Reporting Standards (“IFRS”), which will then converge with GAAP in the 2012 - 2013 timeframe. Since SAP requires U.S. insurance regulators to assess and adopt, amend or reject changes to GAAP affecting insurance accounting, U.S. regulators are reviewing and commenting on international accounting proposals.

Insurance Valuation. This feature of the SMI process involves considering principles-based regulation for life insurance and thereafter property and casualty insurance. At the Fall 2009 National Meeting, the NAIC adopted a principles-based system for life insurance reserves, which is discussed in detail under the heading “Adoption of Amendments to the NAIC Standard Valuation Model Law” provided below. Loss reserve valuation may also be affected by the adoption of IFRS, which uses discounted loss reserves.

Reinsurance. As discussed in greater detail herein, the NAIC adopted the Reinsurance Regulatory Modernization Framework Proposal to create a modernized system for the regulation of reinsurance.

Group Solvency Issues. A working group was formed to study potential revisions to the Insurance Holding Company System Regulatory Act (model 440) and Regulation (model 450) (collectively, the “IHCA”), particularly in connection with insurance group issues that arose in the recent economic downturn. International solvency measures related to groups and the need to develop group-wide supervision will also be considered by this working group.

### ***Group Solvency Issues***

The Group Solvency Issues (EX) Working Group of the SMI (EX) Task Force met on September 23. During interim conference calls, the Working Group reviewed comments from state regulators in connection with proposed improvements to state supervision of insurance holding company

systems. From a timing perspective, the comments were divided between short-term issues related to enhancements to the IHCA and long-term issues such as group supervision, capital benchmarks and international issues. On September 22, the Executive (EX) Committee authorized the Working Group to develop amendments to the IHCA.

The Working Group reviewed the primary areas of concern expressed by state insurance regulators in connection with group supervision, including: evaluation of indicia of control and influence over insurers; regulatory access to information within the holding company structure; agreements within insurance holding company systems; group capital assessment; systemic risk analysis; enterprise risk management; information sharing between state regulators and U.S. and foreign regulators, including participation in supervisory colleges; and recognition of non-U.S. regulatory regimes. A proposed draft of an amended IHCA is anticipated in November; however, it is expected that work on a revised draft of the IHCA will extend through 2010 because various issues, such as participation in supervisory colleges, are currently being studied by the NAIC.

With respect to the acquisition of control and influence over an insurer, the Working Group discussed proposed improvements to the Form A (Acquisition of Control Statement Filing), Form B (Annual Registration Statement Filing) and Disclaimer of Affiliation and Control Filing. Citing lessons learned from the recent sale of various AIG entities, the regulators considered proposals for consolidated Form A hearings managed through the NAIC, and a unified process for the approval of the transfer of control of multiple insurers within a group. In addition, specific attention was devoted to certain difficulties associated with the control approval process where an individual is the ultimate controlling person. In this respect, it was noted that the IHCA does not anticipate an individual as the ultimate controlling person of an insurance group and therefore standards related to the nature and extent of financial information required of such an individual are not sufficiently addressed in the IHCA. The Working Group discussed reviewing standards established by the AICPA in connection with obtaining personal financial information from an individual.

With respect to the registration of insurance holding companies, the Working Group also considered proposed amendments to the model regulation, under which Form B would be submitted to the NAIC in order to provide a centralized filing mechanism without diluting the domestic state regulator's oversight. It was noted, however, that such a filing with the NAIC, which is not a governmental unit, would likely raise issues relating to the maintenance of the confidentiality of such filings.

Attention was also given to the definition of control and standards applied to the disclaimer of affiliation and control. A disclaimer of affiliation and control is authorized under Section 4(K) of the IHCA, which provides that a person may disclaim control in a filing with the insurer's domestic regulator by explaining why the applicant does not or will not control the insurer. The Working Group intends to review the disclaimer process, including an assessment of best practices, during its evaluation of the IHCA. Suggestions have also been received for additions to the definition of control. For example, based on SSAP No. 25 the Illinois Department of Insurance has suggested including within the definition of control the power to cause the direction of the management or policies of an insurer through (i) common management and (ii) contracts for non-management services, where the volume of activity results in a relationship of reliance.

In addition, the Working Group considered changes to the IHCA which would specify standards applicable to certain agreements and transactions between an insurer and a member of its holding company system. The Working Group discussed the possible inclusion of detailed contractual standards such as maintenance of books and records, cost-basis fees and termination provisions in connection with inter-affiliate services and management agreements.

Exchange of information with other financial services regulators, both on the federal level and internationally, was considered by the Subgroup on Supervisory Colleges. The Subgroup will prepare draft amendments to the IHCA in connection with information sharing with federal and international counterparts and state regulators' attendance at and use of supervisory colleges. The development of systems for tracking attendance at supervisory colleges and the development of best practices for regulators attending supervisory colleges is also a goal of the Subgroup. Concern was also expressed regarding the "one-sided nature" of conversations with federal regulators and the Subgroup will explore a framework for proposing regulations to federal authorities requiring information sharing between federal and state financial services regulators.

## **Adoption of Amendments to the NAIC Standard Valuation Model Law**

### ***Principles-Based Initiative***

Guiding principles for the NAIC's consideration of a principles-based approach for reserving were developed in late 2007 by the Principles-Based Reserving (EX) Working Group. The Working Group was established to serve as a coordinating body for all NAIC technical groups involved with projects related to a principles-based approach to reserving. As background, under the Principles-Based Initiative, the NAIC seeks to establish a principles-based regulatory framework, first in the life insurance area and subsequently for property/casualty insurers, that addresses the measurement of risk inherent in the assets, liabilities and associated cash flows related to both the insurance contracts and regulatory capital of insurers. The principles-based approach to the calculation of reserves would permit an insurer to use actuarial and financial assumptions and its risk analysis techniques, experience data and risk management programs to determine sufficient company-specific reserves. Such reserving methodology is intended to address flaws and limitations in the rule-based formulaic reserving methodology currently required of life insurance companies by permitting more flexibility while maintaining regulatory solvency monitoring and protection.

The goals of the Principles-Based Initiative are to create a principles-based framework that: is transparent and objective; is effectuated through state laws and regulations in a manner that maximizes the likelihood of uniformity; is consistent with International Association of Insurance Supervisors' solvency principles; contains principles that address the governance of an insurer; and addresses the financial analysis of an insurer. Accordingly, the Working Group coordinates the activities of various NAIC technical groups that are addressing reserve liabilities and valuation methodologies (including the amendment of the Standard Valuation Model Law and the creation of the Valuation Manual), accounting practices and procedures, annual statement reporting, corporate governance, capital adequacy and RBC and financial examinations. Stage 1 of the Principles-Based Initiative involves actions leading up to the adoption of the amended Standard Valuations Law and Valuations Manual and Stage 2 represents deliverables that can be completed thereafter.

At a joint meeting of the Executive (EX) Committee and Plenary on September 23, 2009, the NAIC adopted amendments to the Standard Valuation Model Law (model 820), which provides methods and assumptions to calculate statutory minimum reserves. Certain sections of the Standard Valuation Model Law are required to be adopted by the states as part of their NAIC accreditation standards in order to promote uniformity. Implementation of the principles-based reserving methodology would require states' adoption of the amendment to their standard valuation laws and the Valuation Manual (referred to in the amended Standard Valuations Law). The Valuation Manual is expected to be completed by the end of this year, at which time it would be considered for adoption by the Executive (EX) Committee and Plenary.

### ***Adoption of the Corporate Governance Guidance for Principle-Based Reserves***

At its meeting on September 21, 2009, the Principles-Based Reserving (EX) Working Group adopted the Corporate Governance Guidance for Principle-Based Reserves, which will be part of the Valuation Manual and provides guidance for the roles of the board of directors, senior management and the appointed actuary and/or other qualified actuaries of an insurance company (or a group of insurance companies), in light of their existing duties as applied in the context of principles-based reserves (the "Guidance").<sup>6</sup>

The board: Under the Guidance, the board of directors is responsible for the general oversight of the principles-based reserves actuarial functions that includes: (i) the process undertaken by senior management to correct any material weakness in the internal controls of the company; (ii) the infrastructure consisting of policies, procedures, controls and resources in place to implement and oversee principles-based reserve processes; and (iii) the documentation of review and action undertaken by the board in the minutes of all board meetings where the principles-based reserving function is discussed.<sup>7</sup>

Senior management: The Guidance also provides that senior management is responsible for the oversight of the principles-based actuarial valuation function, including without limitation, ensuring adequate infrastructure to implement such function, reviewing the principles-based reserve elements for consistency with those for other company risk assessment processes, and reviewing principles-based reserving results for consistency with established risk tolerance of the company in relation to the risks of the products offered by the company, the various strategies used to mitigate such risks and its emerging experience.<sup>8</sup> The Guidance also requires that senior management be responsible for (i) adopting internal controls to provide assurance that all material risks inherent in the liabilities and assets subject to the principles-based reserve valuation are included and such valuations are in accordance with the Valuation Manual and regulatory requirements and actuarial standards; (ii) determining, among other things, the adequacy of resources, the existence of a process to ensure the production of appropriate results, and the existence of a process to validate data for

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<sup>6</sup> The text of the Guidance is available at [http://naic.org/documents/committees\\_ex\\_isftf\\_pbr\\_wg\\_corporate\\_governance\\_guide\\_pbr.pdf](http://naic.org/documents/committees_ex_isftf_pbr_wg_corporate_governance_guide_pbr.pdf).

<sup>7</sup> *Id.*

<sup>8</sup> *Id.*

determination of model input assumption; and (iii) facilitating the board's oversight duties by reporting to the board at least annually regarding such matters, including without limitation, the infrastructure that senior management has established to support the principles-based reserves actuarial valuation function, the critical risk elements of the valuation as applicable, related to the assumptions, methods and models, and their relationship to those for other risk assessment processes, and the summary results of principles-based reserve valuations.<sup>9</sup>

Qualified actuaries. One or more qualified actuary(ies) is (are) responsible for functions, including without limitation, (i) overseeing the calculation of principles-based reserves; (ii) reviewing and approving assumptions, methods and models that are used in determining principles-based reserves and internal standards for actuarial valuation processes, internal controls, and documentation used for such reserves; (iii) providing a summary report to the board and to senior management on the valuation processes used to determine and test principles-based reserves; (iv) providing an opinion on the adequacy of company statutory reserves; and (v) cooperating with the company's auditors and regulators.<sup>10</sup>

### **NRSRO Downgrades of Residential Mortgage Backed Securities**

A substantial portion of the assets of life and health insurers consists of residential mortgage backed securities ("RMBS"), and in recent months a significant segment of AAA rated RMBS have been downgraded by one or more Nationally Recognized Statistical Rating Organizations (collectively, "NRSROs") to below investment grade, resulting in a significant increase of RBC required for the life and health insurers that hold RMBS. An NAIC designation is assigned to any NRSRO-rated securities based on a prescribed formula, and RBC charges are determined by reference to the NAIC designation. NRSROs' ratings focus primarily on the likelihood of the first dollar of loss without much consideration of the severity of loss.

During its September 22 meeting, the Valuation of Securities (E) Task Force discussed a request by the American Council of Life Insurers (the "ACLI") submitted to the Task Force. Originally the ACLI asked that the NAIC permit an increase in the NAIC designation equivalent of the NAIC Acceptable Rating Organization rating of RMBS by reference to a notching process. In its revised request, the ACLI asked the Task Force to consider modifying the current NAIC designation for RMBS for 2009 RBC calculations to better reflect the risk to the holders of RMBS by directing the Securities Valuation Office (the "SVO") to engage an independent analytical services firm to model losses or RMBS held by the insurance industry, which would likely permit life insurers to avoid volatile RBC requirements primarily based on the first-dollar-of-loss ratings methodology. The ACLI stated that its proposal recognizes both the likelihood of loss and the potential severity of loss.

During the Task Force's interim meeting via a telephone conference on July 30, 2009, the New York State Insurance Department expressed its support of ACLI's approach, which involves engaging a consultant under the direction of the SVO to review individual securitization transactions and encompasses the entire RMBS market. During the September 22 meeting, a

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<sup>9</sup> *Id.*

<sup>10</sup> *Id.*



consumer protection advocate on behalf of the Center for Economic Justice asserted its opposition to the ACLI's request, questioning the financial soundness of the life insurance industry and characterizing ACLI's request as additional capital and surplus relief. The advocate further questioned the need to modify the NAIC designation for RMBS while no suggestions for modification were made with respect to any other types of securities, and suggested that regulators either create an independent rating agency or ensure that the rating agencies provide sound ratings. The ACLI responded that the modified NAIC designation may result in higher RBC level than the current level and that its request for modification was due to its recognition of the flawed rating system for RMBS specifically. The Task Force will further discuss this issue at another meeting.

### **NAIC Hearing on the Role of Rating Agencies in State Insurance Regulation**

On September 24, 2009, the Rating Agency (E) Working Group, which was formed earlier this year to evaluate insurance regulators' reliance on credit ratings by NRSROs and to examine potential improvements to the current ratings system, held a public hearing to discuss the role of rating agencies in state insurance regulation. Insurance regulators currently mandate the use of credit ratings to determine capital reserves and to comply with other regulatory requirements. The hearing consisted of three panel discussions, followed by question-and-answer sessions. During the discussions, the panelists examined the evolution of the current ratings system, the steps NRSROs have taken as a result of the recent credit crisis, and the appropriate level of reliance upon the NRSRO ratings by state regulators in enforcing the insurance regulations. The general consensus was that regulators should reduce their reliance on credit rating agencies in order to improve the insurance regulatory system. The Working Group expects to present a final report with any recommendations for corrective action before the Winter Meeting.

#### ***Panel One: Use of Ratings in State Insurance Regulation***

The first panel, which included the Managing Director of the SVO, an insurance regulator, an insurance company executive, and a consumer protection advocate, explored how the current ratings system has evolved and how it functions today. The panel agreed that the RBC calculations presently used by rating agencies and insurance regulators fail to capture certain risks, including market and liquidity risks. Additionally, some panelists argued that the current structural model, whereby issuers pay the rating agencies, as well as the lack of transparency as to how ratings are determined, degrades the ratings' integrity.<sup>11</sup> The panel also questioned the efficacy of insurance

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<sup>11</sup> The federal government is also attempting to address these issues. On September 25, 2009, Congress introduced a discussion draft of the "Accountability and Transparency in Credit Rating Agencies Act." In addition to increasing disclosure requirements and oversight by the SEC and establishing internal oversight requirements for NRSROs, the bill seeks to hold NRSROs responsible for monitoring the information upon which they rely and to hold them collectively liable for any violations of the securities laws. The text of the draft is available at [www.house.gov/apps/list/press/financialsvcs\\_dem/nrsro\\_005b\\_092509.pdf](http://www.house.gov/apps/list/press/financialsvcs_dem/nrsro_005b_092509.pdf).

Additionally, on February 2, 2009, the SEC adopted amendments to Rules 17g-1, 17g-2, 17g-3, and 17g-5. On that day, the Commission also announced additional proposed amendments to Rules 17g-2 and 17g-5; the proposals have not yet been finalized. The amendments are aimed at improving the integrity and transparency of the ratings process by increasing disclosure requirements for NRSROs. The amendments also address potential conflicts of interest by identifying situations in which NRSROs must refrain from acting. The text of the SEC releases announcing the amendments and proposed amendments, respectively, are available at [www.sec.gov/rules/final/2009/34-59342.pdf](http://www.sec.gov/rules/final/2009/34-59342.pdf) and [www.sec.gov/rules/proposed/2009/34-59343.pdf](http://www.sec.gov/rules/proposed/2009/34-59343.pdf).

regulators' reliance upon the NRSRO ratings without a detailed review or affirmation of the agencies' findings. Panelists suggested that the NAIC use and expand the SVO to replace NRSROs, but the SVO representative questioned both the efficiency of such a solution as well as the adequacy of the SVO's resources to perform such functions.

***Panel Two: Rating Agencies - What Happened?***

The second panel, consisting of managing directors of rating agencies as well as critics of such agencies, examined how credit ratings came to be viewed as, at times, the sole consideration in an investor's evaluation of risk. Rating agency executives stressed that while their ratings could be used by insurance regulators as an indication of credit risk (addressing the probability of default and severity of loss upon default), the ratings should not be used as the sole factor for evaluating a security because they do not capture such things as market and liquidity risks. Therefore, the panel encouraged insurance regulators to view credit ratings simply as one would view an investment opinion letter and not as the cornerstone for capital regulation.

Additionally, the panel discussed the steps the agencies have taken in response to the economic crisis, especially regarding their rating of structured securities. While rating agency executives stressed such corrective measures as increased independence of analysts, greater internal oversight and more transparency, their critics asserted that the industry needed to take additional measures to regain the public's trust. Among the critics' suggestions were full disclosure of the information relied upon by the rating agencies and greater emphasis on defining and measuring rating quality. Accordingly, panelists discussed the need for regular updates of securities' ratings, public disclosure of how many securities maintained their initial rating over time and, for structured securities, disclosure of information regarding the underlying collateral. The panel also discussed how the current system, whereby issuers pay the agencies for their ratings, gives rise to potential conflicts of interest. To combat this problem, panelists suggested that insurance companies either create their own organization to rate securities or rate the securities themselves. With the latter approach, one panelist discussed how an independent body could serve as a referee, resolving disputes between insurance companies as to inconsistent ratings of the same security. Panelists also discussed eliminating the current revolving door policy, whereby analysts are potentially hired by the companies they have rated, as a means of limiting potential conflicts of interest.

***Panel Three: Recommendations and Alternatives to How the NAIC Uses Ratings***

The third panel, including executives from advisory and research firms, a professor of economics and a representative from the SEC, addressed whether the current ratings system adequately measures risk, especially that of structured securities. In evaluating the shortcomings of the current system, panelists reiterated that while default risk may be captured by the credit ratings, they fail to address the key issues of market and liquidity risks. Other panelists felt the lack of competition was a detriment to the current system, as the rating industry is dominated by a few large agencies, and argued that if more agencies were allowed to compete, investors would be in a position to use those agencies with the best performance records. The desire for more competition underscores the concept that investors and regulators should take on a more proactive role in the evaluation of securities.

The panelists also discussed potential alternatives for measuring risk. The panel recognized that difficult questions arise when trying to establish a new framework, including whether to take a quantitative or qualitative approach. As a possible new system, multiple panelists discussed a pure expected-loss approach, whereby forecasting models would be completed by independent third parties, who would potentially be accountable to the insurance regulators. The models would take into account loss expectations of a security, including the loss that would arise upon default, and not just the risk of default as done under the current system. Additionally, in addressing the conflicts of interest that may arise when the issuer pays the rating agencies, one panelist suggested the use of a subscriber-based system as an alternative. Such a system is currently used by only a small minority of the rating agencies.

### **Also Noted**

Several other developments during the NAIC's Fall 2009 National Meeting are noted below.

- Adoption of the Natural Catastrophic Risk: Creating a Comprehensive National Plan White Paper. At the Summer 2009 National Meeting, the Property and Casualty Insurance (C) Committee adopted the white paper, Natural Catastrophic Risk: Creating a Comprehensive National Plan, and at a joint meeting of the Executive (EX) Committee and Plenary on September 23, 2009, the NAIC adopted the white paper. While the Committee members agreed that no consensus could be reached on a unified optimal approach to prepare for catastrophic natural disasters that affect different parts of the country, the white paper examines an array of various options for lawmakers to consider, including federal backstop for state-run insurance programs and mitigating methods for damages caused by catastrophic disasters.
- Restructuring Mechanisms for Troubled Companies Subgroup of the Financial Condition (E) Committee. At its meeting on September 22, 2009, the Subgroup exposed to interested parties a white paper on schemes of arrangement and Part VII portfolio transfers (a transfer leaving no recourse to the original contractual obligor/insurer) and similar restructuring mechanisms that are employed internationally for financially troubled insurers.<sup>12</sup> The white paper is exposed until October 15, 2009 and the Subgroup plans to hold a telephone conference to discuss comments in mid-November.
- Producer Licensing. As discussed in "NAIC Highlights - Spring 2009 National Meeting,"<sup>13</sup> on May 21, 2009, the National Association of Registered Agents and Brokers Reform Act of 2009 (H.R. 2554) ("NARAB II") was reintroduced into the House of Representatives by

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<sup>12</sup> The white paper will comprise a review of alternative mechanisms for troubled insurers within and outside the U.S., such as the run-off of existing blocks of business, New York Regulation 141 commutations and Rhode Island voluntary restructurings as well as U.K. Solvent Schemes of Arrangement and Part VII Portfolio Transfers. See NAIC Highlights - Spring 2009 National Meeting at 10 (describing the white paper in further detail).

<sup>13</sup> NAIC Highlights - Spring 2009 National Meeting, *supra* at 12.

Representative David Scott Moore (D-Georgia).<sup>14</sup> NARAB II in its current form amends the Gramm-Leach-Bliley Act (the “GLBA”) to establish the National Association of Registered Agents and Brokers (the “Association”) to oversee licensing, continuing education, and other non-resident insurance producer qualification requirements and conditions that might be adopted and applied on a multi-state basis.

While the NARAB (EX) Working Group did not meet during the NAIC Fall 2009 National Meeting, at a joint meeting of the Executive (EX) Committee and Plenary on September 23, 2009, NAIC adopted the Working Group’s Report “Continuing Compliance with Reciprocity Requirements of the Gramm-Leach-Bliley Act,”<sup>15</sup> which identifies the state requirements imposed on non-resident producers that are consistent or inconsistent with the producer licensing reciprocity requirements of the GLBA and which was adopted by the Producer Licensing (EX) Task Force during the NAIC Summer 2009 National Meeting. During its September 23, 2009 meeting, the Producer Licensing (EX) Task Force adopted the Timeline for Reciprocity Certification, which contemplates that states will be asked to submit completed checklists to the NAIC Legal Division certifying that their respective laws and regulations meet the updated reciprocity requirements.

The NAIC initially formed the NARAB Working Group in 1999 to implement the producer licensing reciprocity requirements of the GLBA.<sup>16</sup> In August of 2002, the Working Group adopted the “Report of the NARAB Working Group: Certification of States for Producer Licensing Reciprocity” (the “2002 Report”), which established a reciprocity framework and recommended that 35 states be certified as reciprocal jurisdictions, and a month after the adoption of the 2002 Report, the NARAB Working Group was disbanded.<sup>17</sup> In 2007, the NAIC commenced a producer licensing assessment process to analyze state producer licensing procedures, and a resulting report identified various requirements imposed upon non-residents that were not specifically addressed within the 2002 Report.<sup>18</sup> The NAIC reconstituted the NARAB Working Group to restate and reaffirm the basic analytical framework within the 2002 Report and supplement that reciprocity standard by applying it to issues not considered by the predecessor NARAB Working Group.<sup>19</sup>

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<sup>14</sup> The text of NARAB II is available at <http://www.govtrack.us/congress/billtext.xpd?bill=h111-2554>. NARAB II was passed by the House last year, but then underwent redrafting to address perceived market legal concerns. See, e.g., Memorandum from NAIC Legal Division to NARAB (EX) Working Group (Nov. 19, 2008) (discussing potential reciprocity issues raised by interested regulators and interested parties regarding potential reciprocity issues with NARAB II under the Gramm-Leach-Bliley Act), available at [http://naic.org/documents/committees\\_ex\\_pltf\\_narabwg\\_memo\\_add\\_pot\\_rec\\_issues.pdf](http://naic.org/documents/committees_ex_pltf_narabwg_memo_add_pot_rec_issues.pdf).

<sup>15</sup> The text of the report is available at [http://naic.org/documents/committees\\_ex\\_pltf\\_narabwg\\_may\\_09\\_reciprocity\\_report.pdf](http://naic.org/documents/committees_ex_pltf_narabwg_may_09_reciprocity_report.pdf).

<sup>16</sup> *Id.*

<sup>17</sup> *Id.*

<sup>18</sup> *Id.*

<sup>19</sup> *Id.*

- Surplus Lines Multi-State Premium Allocation Reporting. In anticipation of the enactment of the NRRRA, which (i) would require the states to establish procedures (through an interstate compact or otherwise) to allocate, among the states, premium taxes arising from a surplus lines placement of multi-state risks, and (ii) permits an insured's home state to require surplus lines brokers to annually file tax allocation reports with such state detailing the portion of the nonadmitted insurance policy premium or premiums attributable to properties, risks or exposures located in each state,<sup>20</sup> the Multi-State Surplus Lines Premium Tax (C) Working Group introduced and discussed a prototype universal tax allocation reporting form during its interim meetings via telephone conferences on August 25 and September 16, 2009. Currently, there is no consensus among the states with respect to the states' taxation of surplus lines premiums on multi-state risks, and development of a universal form that is accepted by all states would be in furtherance of the NRRRA.<sup>21</sup>
- Update on the Revised Model Audit Rule. In 1980, the NAIC adopted the Model Regulation Requiring Annual Audited Financial Reportings. The most recent amendments to the Model Regulation were adopted by the NAIC on June 11, 2006, which changed the Model Regulation's name to the Annual Financial Reporting Model Regulation (as amended, the "Revised Model Audit Rule").<sup>22</sup> During its September 22, 2009 meeting, the NAIC/AICPA (E) Working Group discussed a survey of the states regarding progress toward adopting the Revised Model Audit Rule. The Revised Model Audit Rule would be effectively adopted either by rule or by practice by all jurisdictions by its target implementation date of January 1, 2010.
- New York Receives NAIC Accreditation. At the Fall 2009 National Meeting, the New York State Insurance Department was accredited by the NAIC upon satisfying the requirements under the NAIC's Financial Regulations Standards and Accreditation Program (the "Accreditation Program"). The Accreditation Program aims to establish and maintain standards to promote sound insurance company financial solvency regulation.<sup>23</sup> Accredited state departments of insurance are subject to periodic accreditation reviews by the NAIC to monitor continued compliance with the accreditation standards.<sup>24</sup> Of all 50 states and the District of Columbia, New York is the last jurisdiction to receive the NAIC accreditation.

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<sup>20</sup> NRRRA Title I, § 101(c).

<sup>21</sup> See NRRRA Title I, § 101(b)(1) ("The States may enter into a compact or otherwise establish procedures to allocate among the states the premium taxes paid to an insured's home State . . .").

<sup>22</sup> The text of the Revised Model Audit Rule is available at [http://www.naic.org/documents/committees\\_e\\_naic\\_aicpa\\_adopted\\_model\\_audit\\_rule\\_revisions.pdf](http://www.naic.org/documents/committees_e_naic_aicpa_adopted_model_audit_rule_revisions.pdf). At its meeting on June 13, 2009, the Financial Regulation Standards and Accreditation (F) Committee voted to adopt the Revised Model Audit Rule as an accreditation standard, effective as of January 1, 2010. The next step is individual state actions to enact the Revised Model Audit Rule.

<sup>23</sup> NAIC Financial Regulations Standards and Accreditation Committee website available at [http://www.naic.org/committees\\_f.htm](http://www.naic.org/committees_f.htm).

<sup>24</sup> *Id.*

## Upcoming NAIC Activities

The NAIC's Winter 2009 National Meeting is scheduled to be held in San Francisco, CA from December 5 through December 8, 2009. In the meantime, the NAIC's committees, task forces, and working groups continue to work on the issues discussed 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](http://www.naic.org/meetings_calendar.htm).

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