CLIENT ALERT

# NAIC Report: 2018 Summer National Meeting

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The 2018 Summer National Meeting of the National Association of Insurance Commissioners was held in Boston, Massachusetts on August 4-7, 2018.

State-based legislative and regulatory responses to the Covered Agreement continued on a fast track, principally in connection with proposed amendments to the NAIC's model reinsurance laws and regulations. Other highlights included discussions related to the continued development of the NAIC's group capital calculation tool, the IAIS's recent release of two major public consultation documents, and discussions on the insurance industry's use of new and innovative technologies.

This report summarizes some of the key activities at the Summer National Meeting and, as indicated, NAIC interim meetings and conference calls and other developments leading up to the meeting that may be of interest to our clients in the insurance industry.

DEFINITIONS

Definitions used in this report include:

- "Accreditation Committee" means the NAIC's Financial Regulation Standards and Accreditation (F) Committee.
- "CIMA" means Cayman Island Monetary Authority.
- "ComFrame" means the Common Framework for the Supervision of the Internationally Active Insurance Groups being developed by the IAIS.
- "Covered Agreement" means the Bilateral Agreement Between the United States and the European Union on Prudential Measures Regarding Insurance and Reinsurance entered into by such parties on September 22, 2017.
- "Credit for Reinsurance Models" means the NAIC Credit for Reinsurance Model Law and NAIC Credit for Reinsurance Model Regulation.
- "Dodd-Frank" means the Dodd-Frank Wall Street Reform and Consumer Protection Act.
- "DOL" means the United States Department of Labor.
- "Economic Growth Act" means the Economic Growth, Regulatory Relief and Consumer Protection Act, Public Law 115−174, May 24, 2018, 132 Stat. 1356.
- "Executive and Plenary" means all of the U.S. state insurance commissioners in plenary session along with the NAIC's Executive (EX) Committee.
- "FCA" means the United Kingdom Financial Conduct Authority.
- "FEMA" means the Federal Emergency Management Agency.
- "FIO" means the Federal Insurance Office of the U.S. Department of the Treasury.
- "FRB" means the Federal Reserve Board.
- "FSB" means the Financial Stability Board, a non-profit international body, currently composed of 54 representatives from 25 jurisdictions (including representatives from international financial institutions and international standard-setting, regulatory, supervisory and central bank bodies) that monitors and makes recommendations about the global financial system through the decision-making activities of its plenary. While the

FSB comes to independent policy views on issues and is not run by the G20, the two bodies share a close relationship, with the G20 regularly endorsing the FSB's policy agenda.

- "G-SII" means Global Systemically Important Insurer, as designated by the FSB.
- "IAIS" means the International Association of Insurance Supervisors.
- "ICP" means an Insurance Core Principle, as developed by the IAIS.
- "ICS" means the Insurance Capital Standard being developed by the IAIS to apply to internationally active insurance groups, including G-SIIs. The IAIS has been developing a risk-based global ICS since 2013 pursuant to a directive by the FSB. The IAIS released ICS Version 1.0 and Version 2.0 for public consultation on July 21, 2017 and July 31, 2018, respectively.
- "NAIC" means the National Association of Insurance Commissioners.
- "NASVA" means the North American Securities Valuation Association.
- "NCOIL" means the National Council of Insurance Legislators.
- "NFIP" means the National Flood Insurance Program.
- "NYDFS" means the New York State Department of Financial Services.
- "P&P Manual" means the Purposes and Procedures Manual of the NAIC Investment Analysis Office.
- "Qualified Jurisdiction" means a non-U.S. jurisdiction that, based upon evaluation of the jurisdiction's reinsurance supervisory system, the NAIC recommends be recognized by the U.S. states as a "Qualified Jurisdiction" under the revised Credit for Reinsurance Model Law (#785) and the Credit for Reinsurance Model Regulation (#786), which require an assuming insurer to be licensed and domiciled in a "Qualified Jurisdiction" in order to be eligible for certification by a state as a Certified Reinsurer for reinsurance collateral reduction purposes.
- "SIF" means United Nations Sustainable Insurance Forum, a joint initiative of the Principles for Sustainable Insurance (PSI), the global framework created by UN Environment Finance Initiative, and UN Environment's Inquiry into the Design of a Sustainable Financial System (Inquiry), which consists of a network of leading insurance supervisors and regulators seeking to strengthen the understanding of and responses to sustainability issues for the business of insurance.
- "SVO" means Securities Valuation Office.

- "TCFD" means the Task Force on Climate-Related Financial Disclosures, an initiative established in 2016 by the FSB to provide the financial services sector with recommendations for consistent and reliable means of assessing, pricing and managing climate-related risks in order to enable investors to make better informed decisions and lenders, insurers and underwriters to evaluate their risk over the short, medium and long-term.

- "Treasury" means the U.S. Department of the Treasury.

- "UNPRI" means the United Nations Affiliated Principles for Responsible Investments, an independent organization of investors supported by (but not part of) the UN that works to promote responsible investing.

## TOPICS OF GENERAL INTEREST

### Update Regarding the Covered Agreement

During the Summer National Meeting the Reinsurance (E) Task Force received public comments on proposed amendments to the Credit for Reinsurance Models which were drafted in response to the Covered Agreement, discussed in greater detail here. As described below, the proposed changes to the Credit for Reinsurance Models would result in three distinct categories of non-U.S. reinsurers eligible for either reduced or "zero reinsurance collateral":

- Reinsurers who have obtained certified status from a ceding insurer's domestic state and are domiciled in jurisdictions that, pursuant to the NAIC Process for Developing and Maintaining the NAIC List of Qualified Jurisdictions (the "NAIC Process"), are recognized as Qualified Jurisdictions ("Certified Reinsurers");

- Reinsurers who satisfy financial, rating and commercial standards and are domiciled in a "Reciprocal Jurisdiction" as deemed by the ceding insurer's domestic state ("Reciprocal Jurisdiction Reinsurers"); and

- Qualifying reinsurers from a jurisdiction that has entered into a covered agreement with the U.S., provided that the jurisdiction is recognized as a Reciprocal Jurisdiction by the ceding insurer's domestic state ("Covered Agreement Reinsurers").

At the Summer National Meeting, the Task Force considered comments from 18 different constituents, including domestic and alien insurance and reinsurance companies, industry trade groups and regulators from Maine and Missouri. Overall the comments were positive, noting that the proposed amendments adequately incorporate the terms of the Covered Agreement into the Credit for Reinsurance Models and that the Reciprocal Jurisdiction concept allows well-qualified reinsurers from vetted jurisdictions outside the EU to take advantage of the zero collateral requirement entailed in the Covered Agreement.

Comments from those who expressed concern focused on the following:

- *Greater clarity with respect to the requirements for a Reciprocal Jurisdiction*. The proposed amendments allow each state commissioner to impose additional factors to determine whether a country qualifies as a Reciprocal Jurisdiction. In order to avoid potential regulatory state-to-state arbitrage, commentators recommended that the procedure used to deem a jurisdiction a Reciprocal Jurisdiction be based on a process developed by the NAIC, instead of determination by each commissioner.

- *Inconsistency in treatment between Reciprocal Jurisdiction Reinsurers and EU reinsurers*. Some commentators noted that Reciprocal Jurisdiction Reinsurers could conceivably face more regulatory hurdles than Covered Agreement Reinsurers because of the authority granted to state commissioners to impose additional requirements on Reciprocal Jurisdiction Reinsurers beyond those applicable to Covered Agreement Reinsurers. These commentators argued that non-U.S. jurisdictions could turn to the federal option of seeking their own covered agreements in order to avoid the uncertainty of varying state requirements. Such a consequence, it was argued, would further erode the state-based approach to credit for reinsurance and insurer solvency more broadly.

- *Credit for Reinsurance Models' approach to receivership not consistent with the Covered Agreement.* Certain commentators asserted that Covered Agreement Reinsurers may receive more lenient treatment since a state commissioner does not need to seek from Covered Agreement Reinsurers 100% collateral in the event of a ceding insurer's insolvency or conservation. However, under the proposed amendments to the Credit for Reinsurance Models, state commissioners are requiring Reciprocal Jurisdiction Reinsurers to post 100% collateral. This too could result in other non-U.S. jurisdictions choosing the federal option of seeking their own covered agreement.

In response to the comments, the Reinsurance (E) Task Force intends to expose further amendments to the Credit for Reinsurance Models for public comment by mid-September, and it is anticipated that the final form of the revised Credit for Reinsurance Models will be adopted at the Fall National Meeting held in San Francisco, California.

**International Developments on Group Capital and Group Supervision**

1. IAIS Issues a ComFrame Consultation Package

At the Summer National Meeting, the NAIC's International Insurance Relations (G) Committee heard a report from Romain Paserot, IAIS Deputy Secretary General & Head of Capital and Solvency, on the work of the IAIS. In November 2017, the IAIS announced a unified path between the U.S. and IAIS on developing group capital standards, and the IAIS agreed that ICS Version 2.0 would be conducted in two phases: a five-year monitoring phase, beginning in 2020, followed by an implementation phase, beginning in 2025. For more information on the U.S.'s and IAIS's unified path to developing group capital standards, see Willkie Farr & Gallagher LLP's Client Alert on the 2017 Fall National Meeting, which is available here.

On July 31, 2018, the IAIS issued two major public consultation documents addressing ComFrame, which Paserot referred to as a "big achievement" for the IAIS. One document is focused on the qualitative components of ComFrame and the second is on ICS Version 2.0, which has been presented in a separate document even though it is part of ComFrame.

In terms of a timeline, the IAIS held a public background session on ComFrame and ICS Version 2.0 by teleconference on August 29, 2018. Comments on the two public consultation documents are due by October 30, 2018. The ComFrame Development and Analysis (G) Working Group will develop comments to be shared with the (G) Committee and then the IAIS. There will be another public consultation of further revised ICPs/ComFrame by the end of June 2019, if needed. The IAIS still seeks to adopt ComFrame, including ICS Version 2.0, at its Annual General Meeting in November 2019.

2. ICS Version 2.0 Consultation Document

At the Summer National Meeting, Paserot stated that the IAIS would like feedback on the consultation document related to all the technical components of ICS Version 2.0. In particular, the consultation document is soliciting stakeholder feedback on the following: (i) the components of the reference ICS (*e.g.*, the market-adjusted approach to valuation); (ii) the additional reporting at the option of the group-wide supervisor, which includes Generally Accepted Accounting Principles with adjustments and other methods of calculating the ICS capital requirement; and (iii) the expectations for the IAIS and supervisors during the five-year monitoring phase of mandatory confidential reporting in advance of the formal implementation.

Paserot noted that the IAIS is developing comparability criteria based on its internal work so that it will be able to compare the similarities and differences of the IAIS's and the U.S.'s capital standards. Paserot stated that the IAIS is developing this criteria because it wants to support the development of the aggregation method in the U.S. There is no formal timeline for developing this work since the timing is linked to the NAIC's development of the group capital aggregation method, which is discussed below.

i. NAIC's Increased Involvement with the International Community

In May, the NAIC held its 12th annual International Insurance Forum in Washington, D.C. Topics discussed included the role of insurance in emerging markets, fintech, systemic risk and the impact of big data on the insurance industry. NAIC President and Tennessee Commissioner of Commerce and Insurance, Julie Mix McPeak ("Commissioner McPeak") noted that the "NAIC and its members are actively involved, providing our expertise and views, in various international organizations, working to develop global standards for insurance supervision and address systemic risk in a manner that is practical, flexible and appropriate for insurance activities." Commissioner McPeak echoed these remarks at the opening session of the Summer National Meeting when she noted that the level of international engagement has increased significantly as "[m]ore and more, NAIC members are connecting with [their] counterparts in other countries to coordinate regulatory efforts, identify market risk, and ensure the U.S. market and system of regulation are not disadvantaged."

Also at the Summer National Meeting, Commissioner McPeak and Cindy Scotland, Managing Director of CIMA, signed a Memorandum of Understanding which will allow insurance supervisors in the U.S. and CIMA to coordinate on regulatory issues. Ms. Scotland noted that the agreement represents a milestone and is "mutually beneficial to achieve the goals of economic stability and consumer protection."

**Continued Development of the NAIC Group Capital Calculation Tool**

1. Scope of the Group and Testing the Capital of Non-Regulated Entities

The Group Capital Calculation (E) Working Group continues to develop a group capital calculation tool using a risk-based capital ("RBC") aggregation methodology, which includes (i) creating an inventory of the group's insurance and non-insurance members, (ii) determining whether an entity should be included in the group capital calculation, and (iii) if so, determining the appropriate method for calculating the entity's capital. The Working Group continued to discuss the following topics at the Summer National Meeting: (i) scope of the group (*i.e.*, determining the companies to which the group capital calculation should be applied) and (ii) determining the appropriate method for testing the capital of a group's regulated and non-regulated entities.

Prior to the Summer National Meeting, the Working Group exposed for comment a combined memorandum (the "Combined Memo") on the two topics described in the paragraph above. The Combined Memo proposes a seven-step process for identifying the kinds of companies to be included in the group capital calculation. (Comment letters on the Combined Memo were due on July 20.) In the regulators' view, the starting point is "the insurer's most recent Schedule Y [which is an organizational chart that is required to be filed as part of an insurer's annual statement,] and the ultimate controlling party, along with other relevant Holding Company Filings pertaining to entities directly or indirectly owned by the ultimate controlling party." The Combined Memo sets forth the principles under which the following entities would be removed from the scope of the group: (x) entities that are neither a material source nor a material user of capital and (y) entities that are considered negligible when aggregated. However, a lead state regulator would be permitted to add back excluded entities using specified principles.

With respect to testing the capital of a group's regulated and non-regulated entities, the Combined Memo proposes that each insurer and its minimum required capital as determined by its regulator (or as modified for captives or scalars) should be individually listed in the group capital calculation. Other regulated and unregulated financial entities (with certain exceptions) would also be individually listed in the calculation. The capital of these financial entities would be tested against the guidelines specified in the Combined Memo. For example, a bank's capital would be tested against the minimum amount of capital required by its regulator, and for purposes of the field testing exercise, the testing would be both unscaled and scaled to an RBC equal to 300% of Authorized Control Level. The Combined Memo also contains testing guidelines for non-financial entities.

At the Summer National Meeting, the Working Group reviewed interested parties' comments on the Combined Memo which focused on the composition of the group for group capital purposes; applicability to non-U.S. based groups; and exemptions for groups that do not file an Own Risk and Solvency Assessment (ORSA) report or are subject to consolidated supervision by the Federal Reserve Board.

In addition, proposed revisions to the Combined Memo prepared by a coalition of trade associations (the "Trades Memo") were reviewed. The primary purpose of the Trades Memo, a copy of which is available here, is to provide uniform field testing guidance for field test volunteers and to offer guidelines that are less prescriptive than those set forth in the Combined Memo: "The overall purpose of [the group capital calculation] is to better understand the risks that could adversely impact the ability of the entities within the [scope of the group capital calculation's application] to pay policyholder claims consistent with the primary focus of insurance regulators." To that end, the coalition believes it is critical to differentiate between the broader group, encompassed by holding company laws, and a smaller subset of the holding company system as determined by the group's lead state regulator. In addition, the Trades Memo proposes an exemption from the group capital calculation for U.S.-based groups that are not required to file an ORSA with their lead state regulator. Working Group Chairman, Florida Insurance Commissioner David Altmaier exposed the Trades Memo for comment, along with several related questions, until September 21.

**U.S. Federal Regulators**

1. Financial Regulatory Reform Legislation

The Economic Growth Act, which President Trump signed into law on May 24, 2018, includes provisions meant to roll back certain banking regulations contained in Dodd-Frank.

In addition, Section 211 of the Economic Growth Act, "International insurance capital standards accountability," directs Treasury, the Director of FIO and the FRB to (i) support increasing transparency at any global insurance or international standard-setting regulatory or supervisory forum in which they participate, including by advocating for greater public access to IAIS meetings; and (ii) to achieve consensus positions with the states through the NAIC prior to taking a position with respect to an insurance proposal by a global insurance regulatory or supervisory forum. In addition, Section 211 establishes an Insurance Policy Advisory Committee on International Capital Standards and Other Insurance Issues at the FRB and requires certain reports to Congress by Treasury, the FRB and FIO with respect to international insurance matters.

President Trump issued a signing statement with the Economic Growth Act asserting that the directives to executive branch bodies (*i.e.*, Treasury and FIO) in Section 211(a) contravene the President's "exclusive constitutional authority to determine the time, scope, and objectives of international negotiations," and stating that while the administration "will give careful and respectful consideration to the preferences expressed by the Congress in section 211(a) and will consult with State officials as appropriate," the executive branch will implement Section 211(a) in a manner consistent with the President's constitutional authority to conduct foreign relations. Although this signing statement has no binding legal effect or force, it signals President Trump's objection to the constitutionality of Section 211(a). Accordingly, it remains to be seen whether the executive branch bodies will achieve consensus positions with the states through the NAIC prior to taking a position on international insurance proposals.

In her opening remarks at the Summer National Meeting, Commissioner McPeak applauded passage of the Economic Growth Act and Section 211 in particular as one of the NAIC's legislative priorities. Treasury Secretary Mnuchin also commended the "legislative effort to pass critical regulatory reform for the financial sector" in a statement following passage of the Economic Growth Act.

2. Treasury Names New FIO Director

The Treasury Department has appointed Steven J. Dreyer as the new Director of FIO as of June 2018. Director Dreyer succeeded Michael McRaith, who retired in January 2017, leaving the position vacant until Dreyer's appointment, although Steven Seitz, Deputy Director of FIO, was performing the role of Director during this time. Director Dreyer had previously been an analyst and executive at S&P Global for over 25 years. In his capacity as FIO Director, Director Dreyer will also serve as a non-voting member of the Financial Stability Oversight Council and represent the United States at the IAIS.

Director Dreyer has been reported to have made comments in support of the state-based system of insurance regulation, believing that FIO's role is to be a resource for insurance expertise and to promote awareness of insurance to address issues such as catastrophic losses, access to health insurance and retirement planning, and not to pre-empt the states as the insurance industry's primary regulator.

**Innovation and Technology**

Innovation continues to be a major focus of the NAIC given the rapid changes that new technologies have brought to the insurance industry. One of the themes of the Summer National Meeting, as expressed during the Center for Insurance Policy and Research panel moderated by NAIC CEO Mike Consedine, was whether insurance regulation can keep up with innovation. Related questions that regulators and interested parties grappled with during the Summer National Meeting were whether a regulatory environment can foster innovation while still protecting consumers, and how state insurance departments can work to create regulatory systems that are well-informed rather than reactive.

1. FCA Presentations

Paul Worthington of the FCA presented on how the UK is encouraging innovation in the insurance industry while both protecting consumers and the UK financial system. The FCA has utilized the "sandbox" approach to the development and testing of innovation. It provides a testing ground for new and innovative insurance products on a limited scale with real consumers. The sandbox offers a range of regulatory tools, including the FCA's issuance of an insurance license for a limited period and limitations on the duration of a test period. During these testing periods, firms must still comply with insurance laws and rules, but in a "proportionate" way. Worthington stressed that the FCA does not view the sandbox as a deregulatory initiative, and emphasized that consumer safeguards are crucial. The FCA's assessment is that the sandbox is meeting its objectives by reducing the time and cost of bringing innovative ideas to market. Moving forward, the FCA is considering the idea of a global sandbox, but a key question will be whether the FCA will be able to facilitate multilateral testing. Wisconsin Insurance Commissioner Ted Nickel noted that the NAIC should be the primary point of contact for the FCA in engaging in global sandbox initiatives in the United States.

2. Innovation and Technology (EX) Task Force – Big Data Working Group

The Big Data (EX) Working Group continued its focus on predictive modeling in the insurance industry. Previously the Big Data (EX) Working Group had requested that the Casualty Actuarial and Statistical (C) Task Force appoint a Predictive Analytics (C) Task Force to address the state regulatory review of complex models used in support of personal lines auto and homeowners insurance rate filings. The Task Force was charged with the following goals:

- Draft additions to the Product Filing Examiners Handbook addressing best practices for the review of predictive analytics and models used by insurers to justify rates;
- Recommend filing requirements for rate filings that are based on complex predictive models;
- Facilitate discussion among state regulators regarding rate filing issues of common interest and seek legal assistance to ensure that states can share confidential information during these discussions;
- Facilitate the training and sharing of expertise through predictive analytics webinars; and
- Work with the NAIC technical staff to identify software, databases and other technology to assist analysis of predictive models.

At the Summer National Meeting, the Working Group heard an update from the Casualty Actuarial and Statistical (C) Task Force about these goals. Guidance is being developed on best practices for the review of predictive models, with the aim of providing greater consistency and uniformity of reviews across jurisdictions. It was emphasized that the guidance is not to preempt the authority of state regulators. The Task Force also indicated that it is working to draft a white paper addressing the development of predictive models, including the sources of data that companies are looking to, the ways in which such models evaluate data, and how this affects rate filings with states. The Task Force continues to facilitate training and educational sessions regarding predictive analytics through guest speakers and webinars.

The Working Group also received an update about the research being conducted by the management of the NAIC pertaining to state reviews of predictive models. As most states have indicated to the NAIC that assistance is required in this area, the organization plans to conduct a survey to properly identify the needs of the NAIC membership in conducting the predictive model reviews. The NAIC's Legal Division also provided insight regarding the methods and procedures to be followed by states in sharing predictive modeling information, in order to maintain applicable statutory confidentiality provisions.

**Valuation of Securities Update**

The NASVA and the SVO discussed reorganizing and reformatting the P&P Manual for simplicity and ease of reference. The Task Force exposed the proposed changes for a comment period ending October 20, 2018 and directed staff to prepare a correspondence table so that examiners can easily familiarize themselves with the updated locations of sections that have changed in the revised P&P Manual.

**Liquidity Risk Assessment Update**

At the Summer National Meeting, the Financial Stability (EX) Task Force heard an update from the Liquidity Assessment (EX) Subgroup related to liquidity stress testing. The development of this assessment is part of the NAIC's Macro-Prudential Initiative, which is aimed at identifying and calculating how risks from the broader financial markets and economies impact the insurance sector. Prior to the Summer National Meeting, on a June 25 interim call, Justin Schrader, Chair and Chief Financial Examiner at the Nebraska Department of Insurance, said that the "liquidity framework's primary objective is to understand how large life insurers react to common liquidity stress ... as well as to understand the vulnerabilities of the life insurance sector to liquidity risk." In terms of the scope of the framework's application, the Minnesota regulator noted on the call the importance of focusing on a life insurer's activities (*e.g.*, issuing funding agreements, writing fixed and indexed annuities). At the Summer National Meeting, the Task Force heard that the Subgroup had discussed two approaches to a liquidity stress testing framework: (i) a balance sheet approach and (ii) a cash flow approach. The Subgroup decided to proceed with the cash flow approach since it is more tailored and can easily accommodate forward-looking assumptions.

In the coming months, the Task Force hopes to make a final decision on the scope of the framework application and to finalize the design elements (*e.g.*, what are the stress test scenarios to be tested). The Task Force will also hold discussions on confidentiality and conduct field testing. Mr. Schrader noted that the development process will require significant time and resources and the target for completion will have to be pushed back "well into 2019."

**Briefly Noted**

1. Timeliness Guidelines for Reviewing ORSA Summary Reports

At the Summer National Meeting, the Accreditation Committee considered a referral from the ORSA Implementation (E) Subgroup regarding guidelines to evaluate the timeliness of regulator review of ORSA Summary Reports. The Subgroup collected data on this topic and Kathy Belfi, Subgroup Co-Chair and Director of Financial Regulation at the Connecticut Insurance Department, noted that states face several challenges in reviewing ORSA Summary Reports in a timely manner. The Subgroup recommends that the following time frames be added to the NAIC's ORSA Guidance Manual: (i) if a company is part of a group that is subject to ORSA requirements, the ORSA Summary Report should be analyzed by the lead state regulator within 120 days of receipt; and (ii) if a company is subject to ORSA requirements at the legal entity level, and an ORSA Summary Report has been prepared at that level, it should be reviewed by the domestic state regulator within 180 days of receipt. The Accreditation Committee exposed these guidelines, which would become effective on January 1, 2020, until September 5.

2. Pre-Dispute Mandatory Arbitration Clauses Update

In September 2017, the Pre-Dispute Mandatory Arbitration Clauses (D) Working Group began developing a draft bulletin prohibiting insurers' use of pre-dispute mandatory arbitration clauses, choice-of-venue provisions and choice-of-law provisions in personal lines insurance policies. Final rounds of revisions were made during calls in May and June of 2018, including a revision indicating that arbitration provisions are appropriate in certain specifically defined situations but are otherwise unfair to consumers. The Working Group adopted the Pre-Dispute Mandatory Arbitration Clauses Bulletin (the "Bulletin") during their final meeting at the Summer National Meeting. The Bulletin prohibits the use of pre-dispute mandatory arbitration clauses, as well as choice-of-venue and choice-of-law provisions in personal lines insurance policies. Subsequently, the Market Regulation and Consumer Affairs (D) Committee adopted the Bulletin and disbanded the Working Group.

3. National Flood Insurance Update

On July 31, 2018, President Trump signed legislation that extends the NFIP through November 30, 2018. In addition, FEMA launched a $275 million catastrophe bond in July to transfer risk from the NFIP to the capital markets. This bond will cover FEMA and the NFIP's exposure to flood events caused by U.S.-named storms.

## TOPICS OF INTEREST TO THE LIFE INSURANCE INDUSTRY

### VAIWG Update

While the Financial Condition (E) Committee and the NAIC Variable Annuities Issues (E) Working Group ("VAIWG") did not meet during the Summer National Meeting, on July 31, 2018, the Committee and VAIWG met via conference call to adopt revisions to Actuarial Guideline 43 ("AG43"), Valuation Manual Section VM-21, and the NAIC's Life Risk-Based Capital ("Life RBC") formula (C3 Phase II) that are designed to reduce the level and volatility of the non-economic aspect of reserve and RBC requirements for variable annuities ("VA") products (the "VA Framework"). The VA Framework intends to mitigate the "unprecedented complexity" introduced into the VA statutory balance sheet and risk management by the NAIC's adoption of C3 Phase II (in 2006) and AG43 (in 2009)—which are noted in the VA Framework as the causes that have led to the establishment of VA captives. The Committee's adoption of the VA Framework follows approximately three years of work by VAIWG, including two quantitative impact studies performed by VAIWG's outside consultant, Oliver Wyman. Among other things, the adopted VA Framework:

- Removes the Standard Scenario "floor" from the C3 Phase II RBC calculation;
- Maintains the Standard Scenario reserve amount that is set forth in AG43, but changes its calculation to a stochastic calculation and uses it as an "add-on" to the CTE stochastic reserve amount. The VA Framework proposes that regulators consider in three years whether to remove the Standard Scenario reserve amount and make it a disclosure-only item;
- Makes a number of changes to the stochastic calculation of the Conditional Tail Expectation (CTE) stochastic component of VA reserves;
- Sets forth a new, simplified calculation of the VA C3 RBC charge; and
- Recommends changes to statutory accounting rules and asset admissibility rules governing derivatives used to hedge VA products that are intended to remove accounting asset-liability mismatch problems and increase the admissibility limit with respect to such derivatives.

The VA Framework was adopted unanimously by the Committee, but the NYDFS voted against its adoption at the VAIWG level, noting its opposition to removing the Standard Scenario floor and stating that, in general, RBC and reserve requirements for VA business should be strengthened, and not weakened (as the NYDFS indicated they are in the VA Framework).

While the VA Framework has now been adopted (with no further action required by the Executive and Plenary), the necessary technical language to effectuate its recommendations will now be finalized into AG43, the Valuation Manual

Section VM-21 and the Life RBC formula by the C-3 Phase II/AG 43 (E/A) Subgroup and the Life Actuarial (A) Task Force ("LATF") and will be considered by their parent committees as appropriate. Importantly, one of LATF's charges will be to consider whether the AG43 Standard Scenario should be removed during the three years after the implementation of the VA Framework. In addition, the Statutory Accounting Principles (E) Working Group will continue its work on adopting certain items relating to admissibility of, and accounting treatment for, VA hedges.

Because the changes set forth in the VA Framework will be made to an actuarial guideline, the Valuation Manual and the RBC framework—which are generally automatically incorporated into state insurance laws—no action by state legislatures will be required for these changes to go into effect. However, in certain states (*e.g.*, New York), pending legislation implementing principles-based reserving requires that any amendments to the Valuation Manual must be found by the state's insurance regulator to be in the best interests of the state's policyholders and annuity contract holders. As a result, it is possible that a regulatory process will need to be undertaken in some states before some of the changes required by the adopted VA Framework are implemented.

**Annuity Suitability Discussion Continues**

The Annuity Suitability (A) Working Group continues to discuss proposed revisions to the Suitability in Annuity Transactions Model Regulation (Model #275), which incorporates a best interest standard of care into its existing suitability standards for the sale of annuities. In her remarks at the opening session, Commissioner McPeak noted that the NAIC is "responding to requests from regulators and the industry for an updated and consistent standard of care for consumers considering annuity products," while "working in parallel" to the efforts underway at the federal level, such as with the SEC. As previously reported, the Working Group believes that the decision by the United States Court of Appeals for the Fifth Circuit striking down the DOL's fiduciary rule allows it to work on a new, more appropriate standard.

At its interim meeting at the NAIC Insurance Summit in Kansas City on June 19, the Working Group discussed comments received on Section 6 – Duties of Insurers and Insurance Producers of Model #275. In response to comments received, the Working Group also decided that considering an expansion of the model law to include life insurance products was beyond the scope of the Working Group's current charge. They determined that the Life Insurance and Annuities (A) Committee was the more appropriate forum for such a discussion. NYDFS Deputy Superintendent James Regalbuto disagreed with this position, noting that the Working Group's charge includes the language "[r]eview and revise [Model #275], as necessary," which he believes is broad enough to include a discussion of adding life insurance products. NYDFS Superintendent Maria Vullo raised this same issue when the Life Insurance and Annuities (A) Committee met at the Summer National Meeting. Superintendent Vullo acknowledged the Working Group's decision that the addition of life insurance products to Model #275 was beyond the scope of its current charge, but she wanted to inform the (A) Committee members of her view that she would like to revisit this topic at a later date. We note that there is currently no timeline for expanding the scope of the Working Group's charge. Superintendent Vullo's view is that the best interest standard should also apply to life insurance transactions since they have the same distribution channels as annuities. California Insurance Commissioner Dave Jones supported New York's position.

In terms of next steps, the Working Group will continue to discuss revisions to Model #275 with the goal of presenting a finalized draft to the Life Insurance and Annuities (A) Committee at the 2018 Fall National Meeting.

1. New York Finalizes Amendments to its Annuity Suitability Regulation and Expands Standard to Life Insurance Transactions

Following two notice and public comment periods, the NYDFS issued a final regulation on July 17, 2018, that adopts a best interest standard for insurance companies and producers that sell life insurance and annuity products in New York State. A transaction is in the best interest of a consumer, meaning the owner or a prospective purchaser of a life insurance policy or an annuity contract, when such transaction is in furtherance of the consumer's needs and objectives. Superintendent Vullo said that "[a]s the federal government continues to roll back essential financial services regulations, New York once again is leading the way so that consumers who purchase life insurance and annuity products are assured that their financial services providers are acting in their best interest when providing advice." The amendments to New York's existing regulation related to annuity contracts and life insurance policies will be effective on August 1, 2019, and February 1, 2020, respectively.

**Adoption of Changes to Life RBC Due to Federal Tax Reform**

As previously reported, during the early part of this year, the Life Risk-Based Capital (E) Working Group was focused on changes to the Life RBC calculation necessitated by the decrease in the U.S. corporate tax rate from 35% to 21%. It has been suggested that this tax rate decrease will cause a strain on life insurers' RBC positions due to factors including a reduction in the tax offset for certain Life RBC charges and a reduction in life insurers' deferred tax assets. The Working Group made significant progress on the revisions to certain Life RBC factors in order to account for changes required by the tax reform, and on June 28, 2018, the Capital Adequacy (E) Task Force adopted the changes, which will be effective for Life RBC calculations as of December 31, 2018. No further action by the Executive and Plenary or state legislatures is required to implement these changes.

The Working Group is now preparing an explanatory document for use by regulators that will explain the impact of tax reform on life insurers' RBC ratios and changes made to Life RBC factors resulting from tax reform's adopted by the Capital Adequacy (E) Task Force on June 28, 2018. On a July 20 interim call, members of the Working Group noted that, while these changes are significant, their belief is that it is not likely that these changes will cause a large number of companies to undergo a decrease in their RBC ratios that would be sufficient to trigger the RBC trend test. Nevertheless, the Working Group agreed that it would be helpful for the guidance document to inform regulators that certain life insurers may trigger the trend test solely as a result of the 2017 tax law changes.

## TOPICS OF INTEREST TO THE P/C INSURANCE INDUSTRY

### Adoption of Travel Insurance Model Act

At the Summer National Meeting, the Travel Insurance (C) Working Group of the Property and Casualty Insurance (C) Committee adopted the NAIC Travel Insurance Model Act (the "NAIC Travel Model"), with one revision to Section 9. The NAIC Travel Model uses the NCOIL travel insurance model law as a template. As background, the Working Group had been charged with developing a model law to establish appropriate regulatory standards for the travel and tourism insurance industry. The industry had found that, as travel insurance products do not fit well into standard interpretations of current insurance laws and regulations due to their transient nature and global application, there was a great deal of regulatory uncertainty around providing this type of coverage. The NAIC Travel Model creates a comprehensive legal framework under which travel insurance, which is insurance coverage for personal risks incident to planned travel, may be sold, solicited or negotiated in a state. The NAIC Travel Model contains requirements related to producer licensing, disclosure to consumers regarding the travel insurance offered by travel protection plans, and premium tax. It must now be adopted by the Executive and Plenary.

### Climate Risk

One of the mandates of the Climate Change and Global Warming (C) Working Group is reviewing the impact of climate change and global warming on insurers through presentations by interested parties. Accordingly, the Working Group heard two presentations related to climate risks affecting the insurance industry by speakers from the UN.

In April 2015, the G20 urged the FSB to consider climate risk as part of an issuer's disclosure obligations. In response, the FSB launched the industry-led TCFD. The TCFD was tasked with developing recommendations on climate-related financial disclosures in order to measure and respond to climate change risks. It has focused on four main themes surrounding an organization's responses to climate risk: governance, strategy, risk management and metrics and targets. UNPRI is a participant of the TCFD.

Chris Fowle of the UNPRI summarized a paper entitled "Principles for Responsible Investment Overview of the Task Force on Climate-Related Financial Disclosures Recommendations for Investors." Fowle described the idea that policymakers have an interest in ensuring the financial system is resilient to all forms of risk, including those posed by climate change. He noted that the UNPRI has promulgated a set of voluntary and aspirational investment principles known as "Principles of Responsible Investment" that offer guidance for incorporating ESG (environmental, social and governance) issues into investment practices. UNPRI's reporting framework for companies to comply with these principles is aligned with the recommendations of the TCFD for helping businesses disclose climate-related financial information. As Fowle explained, UNPRI has identified that asset owners, including insurers, will need high-quality and timely data on climate-related risks, and has prepared a guide for asset owners seeking to implement the TCFD's recommendations.

Fowle noted that climate change is a risk multiplier that exacerbates existing issues with energy, resource and food security and weather patterns, and that the full economic impact of the risk will grow over time. Fowle identified two types of climate-related risks relevant to investors: (1) physical risks, which include impacts on insurance liabilities, financial assets and disruptions to trade resulting from frequent and severe weather events, stress to food, energy and resource scarcity that arise from climate change; and (2) transition risks, including impacts from the process of adjusting to low-carbon economies, including technological changes or changes in government policy causing a revaluation of assets as costs and opportunities. Better climate disclosure will assist investors significantly in understanding the financial impacts of climate change on their investments. Fowle ended by explaining that insurance companies should focus on understanding the mandate of the TCFD, and encourage TCFD reporting through the use of the UNPRI framework and through communication with other beneficiaries in a company's system.

The second presentation, entitled "United Nations Sustainable Insurance Forum's Development of Best Practices Regarding Climate Risk for Insurance Regulators," was made by Geoff Summerhayes of the SIF. The SIF, a network of leading insurance supervisors collaborating on sustainability, partnered with the IAIS in order to provide guidance to insurance supervisors. The presentation focused on the jointly issued SIF/IAIS Issues Paper on Climate Change Risks to the Insurance Sector, intended to inform insurers and supervisors of the challenges presented by climate change. The paper provides an overview of how climate change is currently affecting and may eventually affect the insurance sector, including a discussion of physical and transitional material risks impacting underwriting and investment activities and the relevance to the supervision and regulation of the sector.

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