CLIENT MEMORANDUM

NAIC Report: 2013 Fall National Meeting

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The 2013 Fall National Meeting (the "Fall National Meeting") of the National Association of Insurance Commissioners (the "NAIC") was held in Washington, D.C. on December 15-18, 2013.

This report summarizes some of the key activities at the Fall National Meeting that may be of interest to our clients in the insurance industry, as well as developments from NAIC interim meetings and conference calls as noted in this report.

I. OVERVIEW – DISAGREEMENT AND DISSENT

There was a time, in the not-too-distant past, when insurance matters debated at NAIC meetings were the exclusive domain of state insurance regulators and interested industry and consumer groups. That time has passed. Over the past several years, issues debated at NAIC meetings reflect the increasing involvement of federal and international regulators and standard setters. Today, the regulatory goals and standards of the NAIC and state regulators are commonly set by federal and international forces – and state regulators are fighting to explain and maintain the U.S. state system of insurance regulation. During the Fall National Meeting, growing tensions within and among these groups regarding governance and jurisdiction were publicly aired to dramatic effect (at least by NAIC meeting standards). Highlights of these disagreements and dissents are summarized below.

A. FIO v. State Insurance Regulators

On the eve of the Fall National Meeting, the Federal Insurance Office ("FIO") issued its long-awaited report titled "How to Modernize and Improve the System of Insurance Regulation in the United States" (the "FIO Report"). Click here to see our previous report summarizing the FIO Report. The FIO Report concluded that the state-based system of insurance regulation is inherently limited in its ability to regulate uniformly and efficiently and that this lack of uniformity is acutely felt in both financial matters and marketplace oversight. The FIO Report stated:

> The *status quo*, or a state-only solution, will not resolve the problems of inefficiency, redundancy or lack of uniformity, or adequately address issues of national interest. This Report describes some of those areas where federal standards and intervention may be most beneficial.

In the FIO Report, FIO said that it will monitor state regulatory developments and present options for federal involvement as such involvement becomes necessary.

Not surprisingly, citing the threat of federal intervention, a common theme of the Fall National Meeting was uniform state insurance regulation. The chairs of various committees stressed that the states' ability to ward off federal intervention depends on state adoption of NAIC models, including state legislative deferral to NAIC-developed standards as drafted and amended over time. Examples cited by regulators included the incorporation in state law of NAIC-governed rules such as statutory accounting practices and procedures, risk-based capital instructions, the financial examiners handbook and other such standards. In addition, in response to the FIO Report, Senator Ben Nelson, CEO of the NAIC, noted in his welcome letter to the Fall National Meeting that the NAIC "remain[s] focused on ensuring that FIO does the job it was created to do, and not [the NAIC's] job, while recognizing that the FIO can supplement and enhance existing efforts of the NAIC and state insurance regulators to strengthen the position of the United States in international discussions relative to insurance issues."

The release of the FIO Report is a major development in insurance regulation. The role of FIO should be carefully watched as the FIO Report clearly indicates that FIO will become more involved if the federal government concludes that state regulation is inadequate.

B. NAIC – Internal Dissent over NAIC Governance

The NAIC Executive Committee meeting included an unusual public display of disagreement among NAIC members regarding the governance and culture of the NAIC. The discussion was initiated by Connecticut Commissioner Thomas Leonardi, who accused the NAIC of failed leadership, insularity and cronyism. Commissioner Leonardi said that the failure of the NAIC's governance was particularly troubling because the state-based system of insurance regulation faces serious challenges at home (with the ascent of FIO and the Federal Reserve) and abroad (at the International Association of Insurance Supervisors ("IAIS") and the Financial Stability Board ("FSB")). He described the NAIC as a "dysfunctional" group and warned that if it does not fix its governance issues others would be justified in questioning the NAIC's capacity to regulate the world's largest insurance market. In support of his views, Commissioner Leonardi cited the recent public dispute among NAIC members regarding the appropriateness of attending a meeting with President Obama to discuss the Affordable Care Act and a "unilateral" decision by prior NAIC President, Commissioner Kevin McCarty of Florida, to give FIO one of the NAIC's three seats on the IAIS Executive Committee.

The fireworks at the NAIC Executive Committee meeting erupted when Commissioner Leonardi moved that the NAIC Executive Committee direct the NAIC's corporate governance committee (the "CG Committee") to immediately begin work on selecting an external consultant to review NAIC operations and pursue initiatives to (i) clarify the role and authority of the NAIC president, officers and broader membership in key decisions impacting state regulation, particularly with respect to NAIC appointments to external forums such as the IAIS and Joint Forum, (ii) review the NAIC election process and (iii) clarify the role and authority of the NAIC CEO.

Commissioner Stephen Robertson of Indiana offered a counter motion that the CG Committee consider whether engaging an outside consultant is necessary and make recommendations to the Executive Committee. Commissioner Robertson did not establish a deadline for such a report but suggested it could be submitted at the commissioners' round-table discussion in Arizona in February. Pennsylvania Commissioner Michael Consedine supported Commissioner Robertson's proposal, as did North Dakota Commissioner Adam Hamm, stating that this is not a rush and that the prudent approach is to let the CG Committee do its job.

Commissioner Leonardi rebutted Commissioner Robertson's challenge by stating that he had been voicing these concerns for two years without results, and noting that no objections had been raised by regulators when his proposal was discussed behind closed doors the previous day. Commissioner Leonardi's motion was seconded by New York and received support from Illinois and, it seemed, California; however, the swift vote taken against Commissioner Leonardi's motion prevented these commissioners from publicly voicing their opinions. This silencing of the commissioners was described by Commissioner Leonardi as being a good example of what is wrong with the NAIC's practices.

Commissioner Leonardi's motion was ultimately rejected by a majority of the Executive Committee (12-5) and Commissioner Robertson's counter-motion passed. Thus, a decision on if and when an outside consultant will be retained to review the governance issues raised by Commissioner Leonardi will be deferred pending CG Committee study and recommendation.

Immediately prior to the Fall National Meeting, Commissioner Leonardi drafted a letter to the various U.S. state insurance commissioners about these issues, and following the meeting this letter became public and was circulated in the media. The letter criticizes the NAIC as operating under an "imperial presidency," as well as being under the undue influence not only of its officers rather than the Executive Committee, but also of certain former insurance regulators. It specifically criticizes resulting decisions such as the one to give FIO one of the NAIC's three seats on the IAIS Executive Committee. It also takes to task those NAIC members who refused a meeting with President Obama in December.

There have rarely been such public displays of internal dissent by the NAIC. In the wake of the FIO Report, it is critical that the NAIC operate in harmony; otherwise, the threat of federal regulation is likely to gain more momentum.

C. FSOC – Dissent and Criticism by Insurance Members

The Financial Stability Task Force meeting was attended by the two insurance members of the Financial Stability Oversight Council ("FSOC") – Director John Huff of Missouri and Roy Woodall, Independent Member with Insurance Experience. (Pursuant to the Dodd-Frank Wall Street Reform and Consumer Protection Act, Mr. Woodall is the only "insurance" member of FSOC with voting rights. Director Huff is a non-voting member.)

Both Director Huff and Mr. Woodall described their dissents from the recent FSOC vote designating Prudential Financial, Inc. ("Prudential") as a Systemically Important Financial Institution ("SIFI") and also criticized FSOC for its over-emphasis on banking principles to the detriment of the insurance industry. With respect to Prudential, Director Huff and Mr. Woodall issued written dissents from FSOC's determination on the grounds that it was not supported by the record or actual experience; the underlying analysis used scenarios antithetical to a fundamental and seasoned understanding of the business of insurance and the insurance regulatory system; and the mitigating effect of the state resolution and guaranty systems for the insurance company members of the Prudential group was not recognized by FSOC.

Further, Director Huff and Mr. Woodall questioned the very structure of FSOC and proposed that the four voting banking members should not vote on insurance industry matters as to which they have no experience, but rather should rely on the voting and non-voting FSOC members with insurance expertise. In addition, Director Huff noted that such underrepresentation of insurance expertise was perpetuated with respect to the U.S. representatives to the FSB which consists of representation from the Federal Reserve, Securities and Exchange Commission and Treasury Department but not by a representative of state insurance regulators.

II. TOPICS OF GENERAL INTEREST TO THE INSURANCE INDUSTRY

A. Election of NAIC Officers

The following NAIC officers for 2014 were elected:

President: North Dakota Insurance Commissioner Adam Hamm
President-Elect: Montana State Auditor and Commissioner of Securities and Insurance Monica Lindeen
Vice President: Pennsylvania Insurance Commissioner Michael Consedine
Secretary-Treasurer: Kentucky Insurance Commissioner Sharon Clark

B. The Debate Over Group Supervision

1. National and International Support for Group Supervisory Authority

Throughout the Fall National Meeting, state regulators heard the view expressed by many that a formal system of group supervision was essential to regulating financial groups. In the 2009 Financial Sector Assessment Program ("FSAP") of the United States, the International Monetary Fund (the "IMF") stated that many international insurance regulators have supplemented their individual insurance entity supervision with an enhanced supervisory focus at the group level. The IMF recommended that the United States do the same through consolidated financial condition reporting and analysis of the group as a whole (including unregulated affiliates) and further development of colleges of supervisors. Citing the FSAP report, the FIO Report notes that "the state of group-wide supervision in the United States has drawn international attention." While acknowledging the efforts made in adopting the amended Model Insurance Holding Company System Regulatory Act (the "Amended Model HCA"), FIO questions whether the Amended Model HCA's indirect authority grants insurance regulators effective supervision over insurance company affiliates and holding companies. Recognizing the significance of international supervisory colleges, the FIO Report recommended that FIO be included in such colleges "to monitor financial stability and identify issues or gaps in the regulation of large national and internationally active insurers." However, FIO warned that supervisory colleges "are necessary but not sufficient, and do not completely substitute for a consolidated regulator," concluding that "given concerns about the adequacy of solo entity supervision for larger groups … consolidated supervision for large, internationally-active U.S.-based insurance firms will require continued focus and national attention."

2. Forum on Best Practices for Supervisory Colleges

The EU-U.S. Dialogue Project hosted a forum at the Fall National Meeting on best practices for supervisory colleges. Representatives from the NAIC, federal and international regulators, and executives of major insurance companies participated in several panel discussions. Observations on the logistics and substance of recent supervisory colleges included the following: the lead regulator must develop a meaningful agenda (Commissioner Leonardi noted that a draft agenda should be shared with all college participants for comment); the effectiveness of the supervisory college depends on having the right people in the room (both regulators and company personnel); supervisory colleges should focus on group-wide issues and sidebars should be scheduled for purely local issues; and confirming confidentiality of supervisory colleges among all participants is the most important aspect of organizing the college. The panel also noted that, in order to be effective, certain regulators should be assigned ownership of specific regulatory issues going forward.

The Chair of the European Insurance and Occupational Pensions Authority ("EIOPA"), Gabriel Bernardino, who attended the Fall National Meeting and spoke at numerous committee meetings, noted that the European Union ("EU") has implemented global, EU-only and core supervisory colleges. Mr. Bernardino noted that today colleges are organized differently for small groups and large groups, specific tasks are identified by EIOPA and all financial regulators involved in a group are part of the college. Underlining a recurring theme regarding group supervision, Mr. Bernardino said that, in the past, supervisory colleges consisted of non-binding discussions. This will soon end and decisions of the supervisory colleges will be binding on relevant regulators.

The forum also allowed some underlying issues to be raised. The question of how a group is defined for regulatory purposes is key – is the entire group up to the ultimate parent company under review, or is it a smaller sub-set of that company's organization? Adding to that question is the tension created by the U.S. regulators' stance on resisting the "top-down" authority favored by the EU, where the lead regulator ultimately controls the group.

3. IAIS Group Capital Initiatives

Currently, the IAIS is working on two projects relating to group supervision: (i) the development of a Common Framework for the Supervision of Internationally Active Insurance Groups ("ComFrame"), which has been under development since 2010, and (ii) the development of group-wide capital standards applicable to both Globally Systemically Important Insurers ("G-SIIs") and Internationally Active Insurance Groups ("IAIGs"). A final consultation paper on ComFrame was released in October 2013, which will be finalized before field testing of ComFrame begins in 2014, followed by implementation of ComFrame in 2019. The foundation for ComFrame's requirements can be found in the IAIS's insurance core principles, which are intended to be internationally accepted, high-level requirements for the supervision of insurers.

The IAIS announced in October 2013 that it will develop a risk-based global insurance capital standard (the "ICS") to be included within ComFrame. As part of the development of the ICS, the IAIS initially proposed a multi-step process in which it would first develop a backstop capital requirement for G-SIIs; second, develop higher loss absorbency requirements for G-SIIs; and third, develop an ICS for IAIGs. However, the IAIS determined that since the insurance industry does not have an effective global risk-based capital standard to which a backstop could apply, it will initially develop a basic capital requirement (the "BCR"). Once the BCR and ICS have been developed for G-SIIs, the IAIS will determine whether a backstop measure should be developed and applied to IAIGs. The BCR will be initially applied only to G-SIIs, beginning in 2015, although the IAIS will determine later this year whether it should also apply to IAIGs.

4. NAIC Position on Group Supervision

a) Support for Supervisory Colleges and Cooperation Rather than Group Supervisor

The NAIC continues to oppose certain aspects of the group supervisory schemes favored in Europe. In particular, state regulators have not supported a "top-down" group supervision scheme or a global capital standard. The International (G) Committee released a position paper (the "Position Paper") in August 2013 on U.S. insurance regulators' views on ComFrame. While they agree with many of the goals of insurance regulation, they differ on the process for achieving such goals. Comments from the NAIC demonstrated that it would prefer to delay the implementation of ComFrame and instead allow international sharing of information to be accomplished organically through the ongoing use of supervisory colleges. This would allow supervisory colleges to tailor group oversight for a specific group rather than forcing a prescriptive ComFrame approach. The Position Paper also states that "[i]nsurance group supervision in the U.S. is a multi-jurisdictional approach that leverages a group-wide perspective on risk with legal entity level application of regulation. Under such an approach, a single all-powerful group regulator is neither advantageous nor necessary." The NAIC has consistently resisted statements from abroad and from within the United States that the state-based system of insurance regulation is not effective.

b) Charge to Study Changes to Amended Model HCA with Regard to Group Supervision

The Financial Condition (E) Committee was charged with reviewing the Amended Model HCA and considering amendments to address issues that have arisen since its adoption by the NAIC. Rhode Island Superintendent Joseph Torti supported the charge, but stated that this should not delay adoption of the Amended Model HCA by the various states or the accreditation process as it now stands. Commissioner Leonardi also indicated his support for this charge, noting that there is a "perception in the international community that our group supervision is not strong enough," and that this broad charge to consider amendments gives the NAIC additional flexibility (and formal authority) to revisit and review the Amended Model HCA.

Standard setters and international regulators continue to demonstrate support for group supervision and group capital standards, although there are many open issues to resolve. Facing federal and international pressure regarding the state insurance regulators' current group approach, the NAIC has undertaken further review of its Model Holding Company Act and Regulation to consider group solvency and risk.

C. Solvency Modernization Initiative ("SMI")

1. Initial Implementation

It was noted repeatedly that the initial, developmental phase of the SMI at the NAIC is now drawing to a close, and that the implementation stage is about to begin. The SMI White Paper was adopted by the Executive (EX) Committee & Plenary ("Executive and Plenary") at the Fall National Meeting and, in recognition that the work of the Solvency

Modernization Initiative (E) Task Force ("SMI Task Force") in getting SMI off the ground has thereby concluded, the SMI Task Force will be disbanded shortly. The continuation of any work of the SMI Task Force will now be divided up among the (E) Committee and its various working groups for further action, including in the corporate governance, group-solvency, risk-based capital and principal-based reserves areas.

It was noted that the SMI dashboard, which shows the legislative status of state adoption of certain SMI-related NAIC Model Acts and which debuted following the 2013 Summer National Meeting, has been updated.[1]

The work of the SMI Task Force has now concluded, but there is much work in implementation still ahead.

2. Corporate Governance Initiatives

a) Progress Continues with Respect to the ORSA Model Act

State legislators and the NAIC continue to make progress with respect to the implementation of the Risk Management and Own Risk and Solvency Assessment Model Act (the "ORSA Model Act"), which is scheduled to become effective on January 1, 2015. The ORSA Model Act will require U.S. insurers who exceed specified premium thresholds to maintain a risk management framework, regularly conduct an own risk and solvency assessment ("ORSA"), and document the results of the ORSA in a summary report (an "ORSA Summary Report"). The ORSA Summary Report will be submitted confidentially to regulators on an annual basis. The ORSA Model Act has been adopted in seven states (California, Iowa, Maine, New Hampshire, Pennsylvania, Rhode Island and Vermont). Legislation to adopt the ORSA Model Act has been introduced in a number of other states (including Connecticut, Ohio, Texas and Virginia) and additional states have indicated that legislation is under consideration (including New York and Wyoming).

Additionally, the Own Risk and Solvency Assessment (E) Subgroup ("ORSA Subgroup") recently completed its 2013 Own Risk and Solvency Assessment (ORSA) Feedback Pilot Project. Twenty-two insurers voluntarily submitted confidential ORSA Summary Reports for regulatory review; a number of participants had previously volunteered for the 2012 ORSA pilot project. The ORSA Subgroup reported that overall, the ORSA Summary Reports were generally complete and were notably improved when compared to the 2012 submissions.

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

[1] *Available at* http://www.naic.org/committees_e_isftf.htm.

3. Corporate Governance Working Group Continues to Work on Model Laws

Earlier this year, the NAIC approved two Requests for Model Law Development from the Corporate Governance (E) Working Group ("CGWG"): one relating to the development of the Corporate Governance Annual Filing Model Act (the "Corporate Governance Model Act") and one relating to the proposed amendments to the Annual Financial Reporting Model regulation (the "Model Audit Rule"). Both Requests for Model Law Development arose out of the 2009 FSAP review of the United States insurance regulatory system, which suggested a number of enhancements to corporate governance oversight and procedures.

a) The Corporate Governance Model Act Takes Shape

As currently drafted, the Corporate Governance Model Act sets forth the procedural requirements with respect to a new corporate governance annual filing (the "CGAF"). It is not prescriptive and does not impose new corporate governance requirements on insurers. Instead, it describes the elements of the CGAF (including a description of the filer's (i) corporate governance framework, (ii) board of directors' and committee policies and practices, (iii) management policies and practices, and (iv) management and oversight of critical risk areas). As proposed, these elements would be reported by insurers in the NAIC Corporate Governance Annual Filing Guidance Manual (the "CG Guidance Manual"). The CG Guidance Manual, as amended from time to time by the NAIC, would be incorporated by reference into the Corporate Governance Model Act. Similar to the ORSA Summary Report, CGAF information may be reported at the ultimate controlling entity level, an intermediate holding company level or at the level of individual insurers, depending on the corporate governance structure and procedures within an insurance holding company system.

The annual filing requirement and outline of required information in the CGAF was generally supported by the industry; however, the industry generally opposed housing the CGAF's substantive requirements in a guidance manual that may be amended by the NAIC rather than in a statute or regulation requiring state legislative or regulatory action. Members of the industry have proposed that the substantive requirements for the CGAF be incorporated directly into the Corporate Governance Model Act. Regulators, however, have proposed that the CGAF's requirements should be bifurcated, with procedural and technical requirements contained in the Corporate Governance Model Act and substantive information included in a CG Guidance Manual. Under the regulators' favored approach, the CG Guidance Manual would be a living and flexible document developed by the consensus of regulators, similar to the rules for statutory accounting and risk-based capital. By including substantive requirements in a guidance manual, the regulators argue that the CGWG will retain flexibility and the ability to refine guidance without seeking legislative amendments; this flexibility has proved useful in the ORSA context, where the ORSA Guidance Manual has been amended following multiple pilot projects.

In spite of these continuing objections from the industry, the CGWG voted to expose the Corporate Governance Model Act and CG Guidance Manual for a 45-day comment period, which ends on January 31, 2014. The CGWG expressed its desire to have both documents revised and ready for adoption at the 2014 Spring National Meeting.

b) Corporate Governance Working Group Proposes Model Audit Rule Revisions

One recommendation from the 2009 FSAP was that the U.S. insurance regulatory system include a requirement for insurers to maintain an internal audit function. A drafting subgroup of the CGWG met following the 2013 Summer National Meeting to develop revisions to the Model Audit Rule. The proposed revisions were released for a comment period beginning on November 11, 2013 and ending on December 6, 2013.

The proposed revisions will require (a) insurers with annual direct written and unaffiliated premium of at least $500,000, and (b) insurers who are members of a group of insurers with more than $1,000,000 in annual direct written and unaffiliated premium, to maintain an internal audit function. Insurers or insurance groups who are not required to maintain an internal audit function are encouraged to conduct a self-review to determine whether an internal audit function is nonetheless warranted. The internal audit function will review an insurer's corporate governance, risk management and internal controls and provide reasonable assurance to the insurer's audit committee with respect to such controls. The internal audit function is required to be independent and objective; it is proposed that this is satisfied when the chief audit executive reports directly and without restriction to the board of directors. Additionally, the audit committee will receive regular reports on the results of internal audits and any matters relating to the conduct of such audits. As with other recent model law activity at the NAIC, insurers who are part of an insurance holding company system may satisfy this new requirement at the level of individual entities or at the holding company level. The CGWG voted to revise the Model Audit Rule revisions in order to incorporate certain industry and interested party comments and then re-exposed the document for a 45-day comment period ending on January 31, 2014.

The CGWG continues to work to implement recommendations in the 2009 review and hopes to adopt the Corporate Governance Model Act, the CG Guidance Manual and revisions to the Model Audit Rule at the 2014 Spring National Meeting, in advance of the upcoming 2014 FSAP review of the United States insurance regulatory system.

D. International Insurance Matters

1. Solvency II Report

The second Solvency II Quick Fix Directive (the "Second Quick Fix Directive") was adopted by the European Parliament and the Council of the EU at first reading on November 21, 2013 and December 5, 2013, respectively. The Second Quick Fix Directive extends to January 1, 2016 the deadline for the application of the Solvency II Directive. Despite delays in the past, this is now viewed by regulators as a firm date.

On November 13, 2013, the European Parliament, the Council of the EU and the European Commission (the "EC") came to a provisional agreement (the "November Agreement") on the Omnibus II Directive. The purpose of the Omnibus II Directive is to: (i) provide for transitional arrangements for the introduction of the new regime, which had not been adequately dealt with under the original Solvency II Directive; and (ii) facilitate the adoption of subordinate rules that flesh out the higher principles set out in the Solvency II Directive. The parties to the November Agreement came to an agreement regarding the assessment of "equivalency" to Solvency II of regulatory regimes outside of the EU and what transitional arrangement may be made for countries that are not deemed equivalent.

"Equivalence" refers to the concept whereby the EC assesses under Solvency II whether the insurance regulatory regime of a non-EU country is equivalent to Solvency II for three purposes: (i) reinsurance; (ii) group solvency; and (iii) group supervision. The equivalence assessments could affect reinsurance collateral requirements for non-EU reinsurers that reinsure EU cedants, as well as group capital requirements and other compliance requirements generally for non-EU groups with EU subsidiaries and non-EU subsidiaries within EU groups. A finding of non-equivalence could affect the way international groups choose to organize themselves, as well as affect the way international reinsurers consider capital requirements and how they provide security to their EU cedants. A number of countries are currently in the first "wave" of assessment for equivalence but some others, including the United States and Canada, have chosen not to engage in the formal equivalence assessment process.

The November Agreement offers a solution for the equivalence issue for countries outside of the formal assessment process. It is understood that the revised draft Omnibus II text includes a set of criteria by which the EC can unilaterally determine whether the capital adequacy regime of a country is sufficiently equivalent to Solvency II. If it is, the jurisdiction will be granted provisional equivalence, thereby exempting multinational groups having to operate in accordance with both local and European rules. A country will maintain provisional equivalence status for 10 years and this may be extended for additional 10 year periods an unlimited number of times. Therefore, even if a regulatory regime fails to achieve equivalence under the formal process, it may still be deemed equivalent for periods of 10 years under these transitional provisions.

The revised Omnibus II text will be subject to final approval from the Council of the EU and a vote by the European Parliament, which will take place during its February 24-27, 2014 plenary session.

Equivalency under Solvency II continues to be a focus of Solvency II discussions; however, the November Agreement appears to offer resolution to countries including the U.S. that are not formally assessed as Solvency II equivalent.

2. Joint Forum Releases Final Report on Longevity Risk Transfer Transactions

Following its consultative draft in August 2013, in December 2013 the Joint Forum of the Basel Committee on Banking Supervision, the International Organization of Securities Commissions and the IAIS released its final report on longevity risk transfer transactions titled "Longevity Risk Transfer Markets: Market Structure, Growth Drivers and Impediments, and Potential Risks" (the "Joint Forum Report"). Longevity risk transfer transactions are those in which pension plans or schemes purchase coverage for the risk that pension beneficiaries will live longer than expected. The Joint Forum Report analyzes this emerging longevity risk transfer market and makes several observations and recommendations. In particular, with respect to those jurisdictions in which longevity risks may be assumed by non-insurance companies such as banks, the Joint Forum Report encourages policymakers and regulators to consider which sector is in the best position to bear and manage the risk, and which holders of the risk under their supervision have the appropriate knowledge, skills, expertise and information to manage it. The Joint Forum Report also encourages regulators to cooperate with respect to longevity risk transfer transactions both internationally and cross-sectorally in order to reduce possible regulatory arbitrage.

During the Life Insurance and Annuities (A) Committee meeting at the Fall National Meeting, Commissioner Julie Mix McPeak of Tennessee, who chairs this committee, briefly called longevity risk transfer transactions to the attention of the committee and indicated that the Life Risk-Based Capital Working Group may be asked to quantify this market.

Longevity risk transfer transactions are likely to get closer attention by the NAIC and international regulators in 2014. Participants in these markets should carefully follow these developments.

E. The NAIC's Amended Credit for Reinsurance Model Law

1. Bermuda, Germany, Switzerland and UK Approved as "Conditional Qualified Jurisdictions"

Since the 2013 Summer National Meeting, the NAIC has been working to swiftly implement the revisions to the Amended Credit for Reinsurance Model Law, which permits reduced collateral requirements for qualified reinsurers that are domiciled and licensed to transact insurance or reinsurance in a "qualified jurisdiction." An important goal that the NAIC set for itself was to have the "Conditional Qualified Jurisdiction" designations in place by January 1, 2014 in order to allow the 18 states that have adopted the Amended Credit for Reinsurance Model Law[2] to implement the reduced collateral requirements.

At the Fall National Meeting, the Qualified Jurisdiction (E) Working Group (the "Qualified Jurisdiction Working Group") announced that it had completed its expedited review of the international supervisory authorities of Bermuda (Bermuda Monetary Authority), Germany (German Federal Financial Supervisory Authority), Switzerland (Swiss Financial Market Supervisory Authority) and the United Kingdom (Prudential Regulation Authority of the Bank of England), and recommended to the Reinsurance Task Force that these four jurisdictions be granted "Conditional Qualified Jurisdiction" status for one year. The Reinsurance Task Force voted unanimously in favor of this recommendation. Thereafter, the Executive and Plenary adopted this approval. This "Conditional Qualified Jurisdiction" designation may be elevated to a final qualification for each jurisdiction following completion of the full evaluation procedure, which the Qualified Jurisdiction

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2 These states are: Alabama, California, Connecticut, Delaware, Florida, Georgia, Indiana, Iowa, Louisiana, Maine, Maryland, Missouri, New Hampshire, New Jersey, New York, Pennsylvania, Rhode Island and Virginia.

Working Group will be conducting for each of these four jurisdictions in 2014. Ireland and France are next on the Qualified Jurisdiction Working Group's list for expedited review.

Four countries with a significant market share have been approved by the NAIC as "Conditional Qualified Jurisdictions," thereby permitting reduced collateral requirements for qualified reinsurers that are domiciled and licensed to transact insurance or reinsurance in such jurisdictions. This marks a major milestone in the NAIC's implementation of the Amended Credit for Reinsurance Model Law.

2. Reinsurance Financial Analysis Working Group Reviews 30 Reinsurers

The Reinsurance (E) Financial Analysis Working Group (the "Reinsurance-FAWG"), which is a confidential, regulator-to-regulator only group established to provide advisory support and assistance to states in the review of non-U.S. reinsurers' "certified reinsurer" applications, met six times since the 2013 Summer National Meeting. Pennsylvania Deputy Insurance Commissioner Steve Johnson, chair of the Reinsurance-FAWG, reported that the working group reviewed and "passported" 21 reinsurers that had been approved by Connecticut, Florida and New York as certified and eligible for collateral reductions. That is, the Reinsurance-FAWG agreed with, and voted to accept, the approving states' determination as to 21 reinsurers, and other states may now rely on this assessment without having to undertake their own review of these reinsurers. A further two reinsurers are in what Deputy Commissioner Johnson characterized as the "second round" or "follow-up" stages of review, and one reinsurer is in the initial stage of review. Deputy Commissioner Johnson reported that six reinsurers were not passported, either because the Reinsurance-FAWG disagreed with the approving state's determination or because the reinsurer voluntarily elected to not participate in the process. The result of not being "passported" by the Reinsurance-FAWG is that should such reinsurer elect to seek to be certified and eligible for collateral reductions in another state (in addition to the original approving state), such other state will have to conduct its own independent review of the reinsurer.

This "passported" status is only good for one year, so as a next step in 2014, the Reinsurance-FAWG will be working to develop a renewal process whereby it will review the financial condition of the passported reinsurer.

The Reinsurance-FAWG has acted swiftly to review and "passport" 21 reinsurers, which allows other states that have adopted the Amended Credit for Reinsurance Model Law to rely on this determination without having to conduct their own independent review when deciding whether to permit reduced collateral requirements for these reinsurers.

III. TOPICS OF INTEREST TO THE LIFE INSURANCE INDUSTRY

A. Use of Captives and Special Purpose Vehicles

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

The meeting of the Principles-Based Reserving Implementation Task (EX) Task Force (the "PBR Task Force") at the Fall National Meeting was focused on the debate over life insurer reserve relief effected through insurer-owned captive transactions and whether the reserve relief achieved through such transactions should (i) continue to be granted now, or whether a moratorium should be imposed and (ii) be granted in the future once Principles-Based Reserving ("PBR") is fully implemented.

There appeared to be an emerging consensus among the PBR Task Force that insurer-owned captive reserve relief reinsurance transactions should not continue once PBR is implemented, noting that once PBR becomes effective the need for alternative reserve relief arrangements should largely be obviated. Until such time, however, there was not complete agreement on whether new life insurer-owned captive transactions should continue to be approved. Superintendent Torti clarified that reserve relief granted for already approved life insurer-owned captive transactions would continue, while also expressing his view that he would not want any new business added to open-ended existing captive arrangements. In this regard, The Wall Street Journal recently reported that the Securities and Exchange Commission has been in communication with several life insurers with respect to their use and funding of insurer-owned captives/SPVs and the potential costs to the insurers if state insurance regulators were to prohibit their use.

The PBR Task Force was not able to reach a definitive agreement and the discussion ended prematurely as the time for the meeting ran out. Further, the PBR Task Force did not have time to address any other substantive points of order for the meeting, which were deferred to future conference calls. This has been a recurring problem at PBR Task Force meetings, and Superintendent Torti, who co-chairs the PBR Task Force, indicated that going forward more time will be requested for future PBR Task Force meetings.

PBR is intended to replace the current formulaic approach to determining life insurance policy reserves with an approach aimed at better aligning policy reserves to product risks. As previously reported, the NAIC hired Rector & Associates, Inc. to assist the PBR Task Force with certain of its PBR charges, including analyzing life insurer-owned captive transactions and the potential regulatory treatment of these transactions in light of PBR, and assessing the level of resources needed for PBR implementation. An initial report from Rector & Associates was released on September 13, 2013. (the "Rector Report").[3] The Rector Report outlined a number of issues to be addressed, including which actuarial standard should be

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[3] A copy of the Initial Report of Rector & Associates, Inc. to the PBR Task Force is available on the NAIC's website at http://naic.org/documents/committees_ex_pbr_implementation_tf_exposure_rectors_associates_report.pdf

applied, what the appropriate disclosure standards are, and the need for a determination of the appropriate levels of coordination of the statutory financial examinations of the ceding and assuming insurers, such that both sides of the transaction can be evaluated during the examinations. Neil Rector attended the PBR Task Force meeting and requested guidance from the PBR Task Force on the various alternatives to be explored in subsequent versions of the Rector Report.

Superintendent Torti also indicated that a key question will be whether the NAIC is going to choose one actuarial standard with which all will be required to comply. It further remains an open question as to whether that standard will be the Valuation Manual adopted by the NAIC pursuant to the Standard Valuation Law (Model 820), thereby making it reasonably consistent with the reserving approach that would be required if PBR becomes effective.

The PBR Task Force is expected to hold conference calls in the coming months to continue these discussions about captives and implementation of PBR. Interested parties are encouraged to follow these calls closely to stay apprised of this ever-shifting landscape.

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

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

During the Financial Regulation Standards and Accreditation (F) Committee (the “Accreditation Committee”) meeting, Superintendent Torti proposed clarification to the NAIC’s accreditation standards (the “Accreditation Standards”) with respect to state regulation of insurer-owned captives (“Special Purpose Captives”). Superintendent Torti noted that the Accreditation Program allows U.S. insurance regulators to rely on the work of their peers and to be effective solvency regulators while maintaining efficiency and avoiding the duplication of efforts. He further noted that “to ensure such efficiency and the protection of consumers in our state, we have held that all multi-state insurers are subject to the accreditation program." However, language in both the NAIC "Annual Review" document and "NAIC Policy Statement on Financial Regulation Standards" may be subject to interpretation as to whether accreditation requirements apply to Special Purpose Captives. Superintendent Torti argued that single-state licensed Special Purpose Captives that assume reinsurance from cedants operating in multiple states are “multi-state insurers” and as such should be subject to all the accreditation standards applicable to other insurers. The Accreditation Committee agreed to draft for exposure clarifying language regarding multi-state insurers in this regard. To the extent such clarification changes the capital and regulatory standards applied by states to Special Purpose Captives, Superintendent Torti indicated that flexibility would be incorporated into the Accreditation Standards to allow for some seasoning and time for states to make appropriate changes to their laws and regulations.

The impact of this change in the application of the NAIC's Accreditation Standards could be very disruptive to the Special Purpose Captives marketplace. If such a captive is treated as a multi-state insurer under the Accreditation Standards, the particular state insurance department would likely have to apply, among other items, the capital and surplus requirements, risk-based capital requirements, investment laws and credit for reinsurance laws that are applicable to traditional multi-state insurers. This would likely require numerous changes to the laws and regulations in each of the states where different capitalization, reinsurance and related standards are applied to Special Purpose Captives.

The Vermont Department of Financial Regulation submitted a comment letter in support of Superintendent Torti's proposal but indicated that "it is critical that we maintain the status quo for 'traditional' captives owned by non-insurance entities for the management of their own risk." In contrast, the American Council of Life Insurers (the "ACLI") stated at the meeting and in a comment letter that Superintendent Torti's premise was incorrect and that the Accreditation Standards be interpreted as not considering Special Purpose Captives as multi-state insurers. The Delaware Insurance Department also submitted comments indicating that changes in accreditation standards for Special Purpose Captives is premature and should be delayed until after other NAIC committees, including the Principles-Based Reserving Implementation (EX) Task Force, reach a conclusion on the approach on these types of captives. Deputy Commissioner Johnson said that this proposal to consider Special Purpose Captives as multi-state insurers for purposes of the Accreditation Standards needs to be carefully considered and likely "phased in" to make sure there are no unintended consequences.

As for next steps, the NAIC staff will draft clarifying language to the Accreditation Standards in response to Superintendent Torti's letter and after that, such clarifying language would be exposed for comment.

Any such major change to the Accreditation Standards is likely to take some time, but, with the recommendations in the FIO Report that there be a uniform and transparent solvency oversight regime for the transfer of risk to reinsurance captives, there is likely to be more appetite at the NAIC to move forward with this proposal quickly.

B. Private Equity/Hedge Fund Investments in Life Insurers

Private equity and hedge funds have recently demonstrated increased interest in acquiring life insurance companies. Such buyers have focused on insurers whose principal business is annuities which present investment risk. The bidders are often interested in applying their sophisticated investment management expertise to the assets backing the insurance reserves for these annuities.

Recognizing this trend, insurance regulators have begun a re-examination of the insurer acquisition approval standards applicable to private equity or hedge funds or other private investors. Two recent transactions reviewed and approved by the New York Department of Financial Services (the "NY DFS") in 2013 demonstrate this trend. The transactions were the purchase of the U.S. life and annuity business of Aviva plc by Athene Holding, Ltd. ("Athene"), an insurance holding company backed in part by Apollo Management ("Apollo"), and Guggenheim's purchase of certain of the U.S. life and annuity operations of Sun Life of Canada. In both of these transactions, the NY DFS imposed a set of heightened policyholder protections, including maintaining the New York domestic insurer's risk-based capital at an amount not less than 450% and establishing a funded backstop trust account to replenish the domestic insurer's risk-based capital in the event its risk-based capital falls below 450%. The NY DFS has also announced that it is developing new regulations for life insurance acquisitions by private equity and hedge fund buyers to formalize the guardrails it imposed in these deals.

The NAIC has also taken an interest in private equity funds that are buyers or reinsurers of life insurance companies. In May 2013, the Financial Analysis Working Group ("FAWG") issued a paper suggesting to its parent committee, the Financial Condition (E) Committee, that a new NAIC working group be developed to create best practices in connection with acquisitions or reinsurance transactions by private equity entities or hedge funds. In response, the (E) Committee established the Private Equity Issues (E) Working Group (the "PE Working Group") in July 2013. The first meeting of the PE Working Group was at the Fall National Meeting. The PE Working Group, chaired by Deputy Commissioner Doug Stolte of Virginia and having members of the NY DFS on the PE Working Group as well, indicated that it plans on getting input from the private equity/hedge fund industry before making any recommendations.

In furtherance of this, at this first meeting of the PE Working Group, a panel from Athene/Apollo made a presentation. The presenters from Apollo explained that the investments from Athene are not technically from its private equity business. The Apollo presenter also explained that they are a long term investor and that they "have no need to chase short-term results or add bad liabilities." Apollo explained at both the meeting and through comments they submitted in advance to the PE Working Group that private equity investors have an additional advantage of being long term investors since they do not have the quarterly earning pressure imposed by the public, and that they have provided capital to the insurance industry at a time when many other sources of capital were unavailable for most life insurers. In closing the presentation, the Apollo representative indicated that they understand that enhanced regulation may be needed in this area but that it is critical that it is applied on a consistent basis to all life insurance companies, even those not owned by private equity or hedge funds.

Deputy Commissioner Johnson followed up by saying that it was an "excellent presentation and that we agree with a lot of your points." Ed Toy of the NAIC staff then asked whether there was an arms-length situation on investment management agreements between Apollo and Athene, to which the response from the Apollo presenter was "yes" and that "the Athene management team is just about the toughest investment client that Apollo deals with."

At the end of the meeting, the PE Working Group exposed the FAWG issues paper for comment from interested parties until January 30, 2014.

The life insurance industry should carefully monitor the development of potentially new regulations by the PE Working Group since they may be applied on a broader basis than just those life insurers owned by private equity or hedge funds.

IV. TOPICS OF INTEREST TO THE P/C INDUSTRY

A. Mortgage Guaranty/FHA – Lender-Placed Insurance Data Call Moves Forward

1. Mortgage Guaranty Insurance

Mortgage insurance transfers a borrower's default risk from the lender to the mortgage insurer. The housing collapse of 2008 and ensuing wave of mortgage defaults resulted in substantial losses for private mortgage insurers. In late 2012, the NAIC formed the Mortgage Guaranty Insurance (E) Working Group (the "MGI WG") to study whether, given the events of prior years, changes to the solvency regulation of mortgage insurers were merited. The MGI WG identified several issues facing the mortgage guaranty industry, including competitive pressures among mortgage insurers resulting in relaxed underwriting standards as well as generous dividend practices that failed to recognize actual profits of the insurers in the longer term. In mid-2013, the MGI WG published a "concept list" of twelve potential regulatory changes and thereafter drafted amendments to the NAIC Mortgage Guaranty Insurers Model Act (the "MGI Model"), exposed for comment on November 25, 2013.

The proposed revisions to the MGI Model principally relate to (i) capital and reserve standards including increased minimum capital and surplus requirements, mortgage guaranty-specific risk-based capital standards, dividend restrictions and contingency and premium deficiency reserves; (ii) limitations on the geographic concentration of mortgage guaranty risk, including state-based limitations; (iii) restrictions on mortgage insurers' investments in notes secured by mortgages; (iv) prudent underwriting standards and formal underwriting guidelines to be approved by the insurer's board; (v) the establishment of formal, internal Mortgage Guaranty Quality Control Programs with respect to in-force business; (vi) prohibitions on reinsurance with bank captive reinsurers; and (vii) incorporation of an NAIC Mortgage Guaranty Insurance Standards Manual.

Written comments on the MGI Model submitted by a group of mortgage insurers caused some concern by regulators. Noting that the regulators worked closely with industry during the housing crisis and the NAIC undertook this review only when the worst of the crisis had passed, Deputy Commissioner Johnson expressed his disappointment with the industry's comments. Other regulators noted that industry should suggest how to prevent lax underwriting and enable the industry to raise sufficient capital during the midst of a financial crisis.

Industry representatives spoke at the meeting and apologized for any miscommunication. They emphasized a few points, including a desire to make the requirements less prescriptive in general, and informing regulators that the industry intends to submit heavily revised Master Policy forms, along with a request for regulatory assistance with processing them. More specific suggestions from industry representatives included changing state-specific limitations on business to acknowledge smaller areas such as metropolitan areas, using a risk-sensitive model in order to avoid eliminating mortgage guaranty insurer investment in certain unrelated real estate investments, and altering the 95% loan-to-value ratio.

Wisconsin Commissioner Ted Nickel reminded the industry that the FIO Report recommends "robust national solvency and business practice standards, with uniform implementation" and stated that this would require the establishment of "federal oversight of federally developed standards applicable to mortgage insurance."

While the NAIC has proposed substantial revisions to the existing MGI Model, we expect continuing discussion and possible further changes, potentially including those made in reaction to FIO. Although originally the comment period on this draft was set to run through January 9, 2014, at the Fall National Meeting it was voted to extend the exposure period through February 15, 2014, pursuant to industry request.

B. TRIA Reauthorization Uncertainty Continues to Cause Concern

Congressional inaction regarding the reauthorization of the Terrorism Risk Insurance Act ("TRIA"), which is currently set to expire on December 31, 2014, continues to cause concern in the marketplace. TRIA provides a federal backstop for insured losses caused by terrorist acts and plays an important role in the insurance markets and the broader U.S. economy. Kevin McKechnie of the American Bankers Association noted during his presentation to the NAIC's Terrorism Insurance Implementation (C) Working Group at the Fall National Meeting that brokers and insurers would be inclined not to include terrorism coverage but for the federal backstop provided by TRIA. Most banks, however, require terrorism coverage in connection with loans given for large commercial projects. Thus, without a reauthorization of TRIA, there is a risk that banks may start, in the very near term, to start writing down loans that do not have terrorism coverage in place for the entire term of the loan. Members of the Terrorism Insurance Implementation Working Group also noted that states have already begun receiving conditional filings from insurers containing exclusions of terrorism coverage in anticipation of TRIA not being extended.

The NAIC's support for the reauthorization of TRIA is well known, having adopted a formal resolution of support at the 2013 Summer National Meeting. This support was reiterated at the Fall National Meeting by members of the Terrorism Insurance Implementation Working Group.

If you have any questions regarding this memorandum, please contact one of the following members of our Insurance Transactional and Regulatory Practice Group or the Willkie attorney with whom you regularly work.

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