

NAIC 2018 Summer National Meeting

August 24, 2018

The National Association of Insurance Commissioners (“NAIC”) held its 2018 Summer National Meeting from August 4 to 7, 2018 in Boston. In this update, we highlight meeting developments of particular interest to our insurance industry clients.



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Acronyms and abbreviations used in this report:

- ACLI: American Council of Life Insurers.
- ComFrame: Common Framework for the Supervision of International Active Insurance Groups.
- EU: European Union.
- FSB: Financial Stability Board.
- IAIS: International Association of Insurance Supervisors.
- ORSA: Own Risk and Solvency Assessment.
- RBC: NAIC risk-based capital.

Life Insurers

Suitability in Annuity Transactions

At the 2018 Spring National Meeting, the **Annuity Suitability (A) Working Group** reopened the comment period regarding proposed revisions to the NAIC Suitability in Annuity Transactions Model Regulation (the “Model Regulation”), including whether to adopt a “best interest” standard for the sale of annuities or to maintain the existing “suitable” standard.

The Working Group then met in person on May 31 and June 1 in Kansas City to hear comments from stakeholders on proposed revisions to the Model Regulation. The Working Group explained that after the two-day session, it would begin by focusing on the “Duties of Insurers and Insurance Producers” section of the Model Regulation, which contains the current “suitable” standard. Revisions to that section would inform amendments to other sections of the Model Regulation.

Additionally, the chair and vice chair of the Working Group announced that they had met with U.S. Labor Secretary Alexander Acosta and SEC Chairman Jay Clayton to discuss the NAIC’s work and reiterate the NAIC’s intention to work with federal officials to develop a uniform and consistent standard across all annuity product sale platforms regardless of the type of product.

Comments on proposed revisions to the Model Regulation were received from insurance trade groups, consumer advocates and several Working Group members. Proposals included an enhanced suitability standard with additional disclosures of cash compensation, a best interest standard and disclosure of “material conflicts,” and a best interest standard for both annuities and life insurance.

At the Summer National Meeting, the Working Group discussed its decision not to consider suggested revisions to the Model Regulation that would expand the Model’s scope to include life insurance products. The Working Group felt that such proposed changes were beyond the scope of its current charge and more appropriately addressed by the **Life Insurance and Annuities (A) Committee**.

The Working Group also discussed comments received on the definition section of the Model Regulation, including definitions for new terms such as “cash compensation,” “consumer,” “intermediary” and “material conflicts of interest.” The chair of the Working Group took a series of straw votes to gauge the members’ views with respect to the proposed definitions. Although there was some agreement among the members, the discussion relating to a number of the proposed definitions—including “material conflicts of interest” and “consumer”—reflected some of the underlying policy divisions

among the members regarding the proper balance between the interests of consumers and producers and whether the revised regulation should apply to in-force transactions, replacements or any transaction that generates compensation for the producer.

The next day at the **Life Insurance and Annuities (A) Committee**, the chair of the Working Group stated that although the Working Group was making progress, an additional meeting or two, including an in-person meeting, would likely be held in order to finalize the draft revisions, which the Working Group hopes to present to the Committee at the Fall National Meeting in November.

New York expressed support for expanding the Model Regulation to include life insurance and offered its own recently adopted best interest regulation, which includes life insurance and which was adopted after two public comment periods, as a model for the Working Group to consider. Ultimately, New York acquiesced to the Working Group's narrower interpretation of its charge, but requested that the Committee consider expanding the Model Regulation after the Working Group completes its work. This view was supported by California and Washington, D.C., and the chair of the Committee stated that it will consider including life insurance in the Model Regulation at that time.

Reinsurance

At the 2018 Spring National Meeting, the **Financial Condition (E) Committee** directed the **Reinsurance (E) Task Force** and other working groups to revise the Credit for Reinsurance Model Law and the Credit for Reinsurance Model Regulation in order to conform to the requirements in the Covered Agreement regarding EU reinsurers. Specifically, the Committee sought to provide reinsurers domiciled in NAIC-qualified jurisdictions outside of the EU with reinsurance collateral reductions that would be similar to those that would be implemented under the Covered Agreement ("Reciprocal Jurisdictions") and that would include provisions regarding group supervision, group capital, information sharing and enforcement.

Following the Committee's direction, on June 21 the Task Force released for public comment proposed revisions to the Credit for Reinsurance models. Eighteen comment letters were received in response. Although there was general agreement with the NAIC's development of the "Reciprocal Jurisdictions" construct, some criticized the discretion given to individual commissioners to determine whether or not a Reciprocal Jurisdiction identified by the NAIC would be recognized as such in the commissioner's state. These comment letters requested that instead, states accord the same recognition to a Reciprocal Jurisdiction designated by the NAIC as they would for an EU jurisdiction under the Covered Agreement. Other themes addressed in the comment letters included: (i) requests that the revisions to the Credit for Reinsurance models follow the terms of

the Covered Agreement as closely as possible; (ii) support for the inclusion of detailed language about implementation of the Covered Agreement in the model law rather than the model regulation; and (iii) agreement with regulators' efforts to ensure that any jurisdiction that receives the benefits of reduced collateral under the proposed revisions to the Credit for Reinsurance models accords the same treatment to U.S. insurers and recognizes the whole of the U.S. state-based insurance regulatory system.

The Task Force plans to expose revised drafts of the models by mid-September with a goal of finalizing revisions to the models by the 2018 Fall National Meeting in November.

Risk-Based Capital

RBC and Tax Reform Update

At the 2018 Spring National Meeting, the **Life Risk-Based Capital (E) Working Group** heard presentations from the American Academy of Actuaries and the ACLI on how life risk-based calculations were affected by federal tax reform legislation and changes to the life RBC formula proposed in light of that reform. In its subsequent weekly conference calls, the Working Group adopted certain changes with a focus on the impact of the tax rate change. The **Capital Adequacy (E) Task Force** adopted the Working Group's recommendations in June and noted that additional changes to the RBC formula may be considered in the future for better reporting but should not impact resulting RBC calculations.

RBC Factors for Bonds

The **Property and Casualty, Health and Investment Risk-Based Capital (E) Working Groups** heard an updated report from the American Academy of Actuaries relating to proposed RBC bond factors for property/casualty and health insurers. The Academy's initial proposal on life RBC bond factors was issued in October 2017 as part of the NAIC's effort to increase the number of life RBC bond factors from 6 to 20 to better correspond with the framework used by rating agencies and the NAIC's new, expanded designations. The October report also provided the first updates to the health and property/casualty RBC factors since they were implemented in the 1990s.

The Academy's report proposed property/casualty bond risk factors for investment grade bonds that would be somewhat greater than current risk factors for all rating classes other than triple-A bonds. For example, the current property/casualty bond factor for bonds designated NAIC 1, which includes bonds with any single-A rating or higher, is 0.3 percent. Under the proposed factors, bonds in the lowest A category would

have a 1.5 percent charge, which decreases to 0.4 percent for bonds in the highest A category below triple-A. Bonds carrying any triple-B rating now have a 1 percent factor, which would increase to 2.5 percent for the lowest triple-B rating and 1.8 percent for the highest triple-B rating.

The report's proposed health bond risk factors for investment grade bonds would be lower than current health base risk factors for more classes than for property/casualty, based on the view that the shorter time horizon offsets some, if not all, of the considerations that resulted in increased property/casualty base risk factors. All double-A rated bonds would be reduced from 0.3 percent to either 0.1 percent or 0.2 percent, while single-A bonds would increase to 0.5 percent and 0.7 percent. Bonds rated triple-B would increase above the current 1 percent to a maximum of 1.5 percent.

The report recommends higher bond factors for below investment grade bonds—rated BB+ (or Ba1) or lower—because of new data and a new approach with more transparent assumptions than the original risk factors. The Academy noted that investment grade bonds constitute 94 percent of fixed-income assets for both health and property/casualty insurers (based on 2016 data).

The **Investment Risk-Based Capital (E) Working Group** exposed the Academy's report for a 60-day public comment period ending October 4, 2018.

The **Property and Casualty and Health Risk-Based Capital (E) Working Groups** considered and rejected a proposal to allow all insurers to report NAIC designations on Schedule BA (Other Long-Term Invested Assets); currently only life insurers and fraternal companies may do so. The **Property and Casualty Risk-Based Capital (E) Working Group's** analysis projected that 95 percent of property/casualty companies report no Schedule BA assets with underlying characteristics of bonds, mortgage loans or fixed-income instruments, and that the 5 percent of the companies that might be affected would have their RBC action level affected positively.

Similarly, the **Health Risk-Based Capital (E) Working Group's** analysis indicated that 98 percent of health companies report no BA assets with underlying characteristics of bonds, mortgage loans or fixed-income instruments. Among the 2 percent of companies that might be affected, none would experience a change in RBC greater than 5 percent or see any change in company action levels.

Among the reasons given by the Working Groups for rejecting the proposal (at least for now) was the minimal impact the proposal is expected to have and the Working Group's view that the purpose of the RBC formula is to identify weakly capitalized companies, rather than to rank insurers or to aid in determining companies' investment strategies.

The **Capital Adequacy (E) Task Force** later adopted the reports of each of the three RBC working groups.

Property/Casualty Insurers

Big Data

The **Big Data (EX) Working Group** heard a presentation by Eric T. Sondergeld of LIMRA on the uses of data for life insurance products underwriting. He provided an overview of the goals and challenges of automated underwriting, trends in market adoption and the use of third-party vendors in this process. He noted that underwriting at half of all companies is now fully or partially automated, and more than 80 percent of companies that have not automated their underwriting plan to do so.

He also discussed the wide range of sources for underwriting data, including MIB (Medical Information Bureau), prescription drug databases, motor vehicle records, lab results and LexisNexis and other similar electronic databases. The primary challenges to adoption and implementation thus far have been allocating sufficient human resources to guide, supervise and implement the automation; working and integrating automation into the legacy systems; and continually updating these automation computer programs.

The Working Group also heard an update on the progress of the **Casualty Actuarial and Statistical (C) Task Force** in developing guidance on best practices related to regulatory review of predictive models. The Task Force intends to present a white paper that addresses sources and selection of data, predictive modeling and the effects on rate filings.

The NAIC's Legal Division discussed the ways in which the confidential information used in predictive modeling is shared with regulators, with the goal of creating a framework for confidential information to be accessed and shared by state insurance regulators while still protecting trade secrets.

The **Innovation and Technology (EX) Task Force** heard an update from South Carolina about its adoption and implementation of the NAIC Model Data Security Law, which becomes effective in that state on Jan. 1, 2019. Thus far, South Carolina is the only state that has enacted the model, which is similar to the New York cyber regulation that has been in effect since March 1, 2017. Rhode Island, Washington, D.C., Vermont and Louisiana are considering enacting the model law and other states are expected to do so next year.

At the **NAIC/State Government Liaison Committee**, South Carolina reported that federal officials expressed a favorable view of the new law it enacted and expressed a willingness to adopt a similar statute at the federal level if there is not sufficient action across all states in the next five years or so—and that such a federal law would preempt similar state laws. This final observation elicited some surprise from the audience.

The Task Force also heard a presentation from the UK’s Financial Conduct Authority (“FCA”) on its experiences and lessons from working with innovators and the FCA’s regulatory “sandbox.” The FCA representative noted that in the UK, the Insurtech and FinTech industries are distinctly separate. He explained that the trends they are seeing in InsurTech include innovation around the claims process (*i.e.*, how to make this process more efficient for firms).

Group-Wide Supervision

Group Capital

The **Group Capital Calculation (E) Working Group** continued to develop a group capital calculation with the goal of initiating field testing in 2019. Following the 2018 Spring National Meeting and subsequent conference calls, the Working Group exposed a memorandum defining a “group” and the treatment of non-insurance entities. The Working Group received a number of comment letters, including one signed by the American Insurance Association, the National Association of Mutual Insurance Companies, the Property Casualty Insurers of America and the Reinsurance Association of America (the “Joint Trades Letter”).

Two key features of the Joint Trades Letter are an inventory approach to the group capital calculation, starting with the insurer’s most recent Schedule Y, and a distinction between “insurance group” entities and legal entities in the “Broader Group” that are controlled by the insurer’s ultimate controlling person. The Joint Trades Letter suggests that the group capital calculation would include all entities within the insurance group, all other financial entities within the Broader Group and all non-financial entities within the Broader Group that pose material risks to the insurance group. The Joint Trades Letter suggests that the lead state regulator would have discretion to determine which entities should be included within the scope of the group capital calculation. The Joint Trades Letter also suggests that U.S.-based groups that do not have to file an ORSA report with their lead state regulator should be exempt from preparing a group capital calculation, a suggestion that the Working Group agreed to consider but did not express enthusiasm for.

Other speakers at the meeting emphasized the need for the group capital calculation to mirror existing state legal entity rules as closely as possible to avoid creating a separate capital management system.

The Working Group annotated the Joint Trades Letter with eight questions focusing on the mechanics of field testing the proposed group capital calculation and then instructed NAIC staff to expose the letter for a 45-day comment period ending September 21.

International Insurance

IAIS Activities

The **ComFrame Development and Analysis (G) Working Group** heard an update on the IAIS's ongoing public consultations on ComFrame and the insurance capital standards ("ICS"). The IAIS continues to expose revisions to various Insurance Core Principles ("ICPs"), with comments on ICP 6 (changes in control and portfolio transfers) and ICP 20 (public disclosure) due by August 28.

In addition, the IAIS has exposed for public comment ICS 2.0, which seeks to resolve issues related to the technical aspects of valuation and capital resources. Comments are due by October 30. A conference call providing background information on the exposure draft will be held on August 29, 2018 and will be open to the public.

The **International Insurance Relations (G) Committee** heard an update on the IAIS's plans to fill the gap that will arise when the World Bank and IMF stop conducting Financial Sector Assessment Program reviews. The IAIS intends that its assessment process will provide a robust review process of supervisory practices and regulatory frameworks. A pilot of the assessment process is scheduled for later this year.

Long-Term Care Insurance

During the 2018 Spring National Meeting, representatives of ACLI and America's Health Insurance Plans made a presentation to the **Joint Long-Term Care Insurance (B/E) Task Force** about the lack of uniformity in state regulators' determinations of requests for long-term care insurance rate increases. At this National Meeting, the Task Force heard a presentation from representatives of the Idaho, Nebraska and Utah insurance departments regarding a potential multistate rate approval system. The proposed system hopes to provide relief to states facing resource constraints when

considering rate increase requests from insurers, while bringing uniformity to regulators' actuarial analysis of rate increases.

The proposal calls for the NAIC to create a new subgroup that regulators could choose to join. When an insurer presented a rate increase request to the subgroup, one or more states in the subgroup would volunteer, or, if no state volunteered, an outside expert would be hired to provide the necessary actuarial analysis to evaluate the requested rate increase. The subgroup would then generate a report that the insurer could include with its rate increase filings in each state. Approval of the requested rate increase would remain subject to regulator discretion. The members of the Task Force had a number of questions about the proposal, including the overlap with the existing work of the Interstate Insurance Compact and with the work being done by the **Long-Term Care Pricing (B) Subgroup**. The Task Force stated that it would hold a conference call to further discuss this issue.

The Task Force also received a report from the Subgroup about its progress in developing a more transparent and predictable process for approving long-term care rate increases. The Subgroup has developed a resource guide for regulators that describes the two methodologies that states use to review rate increases. The resources guide was exposed for comment in July and August, and the Subgroup expects to develop a final version of the resource guide by the 2018 Fall National Meeting in November.

Financial Stability Task Force

Macro-Prudential Monitoring

The **Financial Stability (EX) Task Force** heard a report from the **Liquidity Assessment (EX) Subgroup** on its progress developing a liquidity stress testing framework. The Subgroup exposed a memorandum, which reflected comment letters received on a prior document about the same issue, outlining six products and activities for which minimum dollar thresholds would be used to determine which insurers would be subject to the framework. These products and activities are:

1. fixed and indexed annuities
2. derivatives
3. funding agreements and guaranteed investment contracts
4. securities lending
5. repurchase agreements
6. borrowed money, including commercial paper

The Subgroup calculated that, based on available data and the criteria set forth in the memorandum, 21 insurance groups would be required to participate in liquidity stress testing. Comments on the memorandum are due by August 31.

The Subgroup also reported that it plans to field test its proposed framework in 2019 and does not expect a final framework to be developed until late 2019.

At the 2018 Spring National Meeting, the **Receivership and Insolvency (E) Task Force** had begun the process of considering three referrals that it had received from the **Financial Stability (EX) Task Force** which relate to assessing recovery and resolution planning in light of the macro-prudential initiative. The Task Force organized three drafting groups to focus on each of the referrals.

During this meeting, the Task Force received an update on the progress of the three drafting groups. Two of the drafting groups will review the resolution and recovery work products of the IAIS, FSB and the European Insurance and Occupational Pensions Authority. The third drafting group will discuss misalignment in federal and state laws with respect to temporary stays of termination of netting agreements for qualified financial contracts.

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Please do not hesitate to contact us with any questions.

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