NAIC 2009 FALL NATIONAL MEETING

September 28, 2009

To Our Clients and Friends:

The National Association of Insurance Commissioners (the "NAIC") held its 2009 Fall National Meeting (the "Fall Meeting") from September 21 to 24, 2009, in National Harbor, Maryland. This Client Update highlights some of the developments from the Fall Meeting that are of particular interest to many of our insurance industry clients, including developments relating to: (1) a proposal by the NAIC for a "National Insurance Supervisory Commission;" (2) the regulation of insurance holding company systems; (3) capital and surplus relief for life insurers; (4) principles-based reserving for life insurers; (5) residential mortgage-backed securities held by life insurers; (6) the statutory accounting treatment of insurer investments in Re-REMICs; (7) the modernization of reinsurance regulation; and (8) the regulation of annuity sales.

On the whole, developments at the Fall Meeting demonstrate a growing commitment by the NAIC to pursue comprehensive insurance regulatory reforms. While regulators have shown a continuing interest in achieving increased national uniformity in the regulation of insurance, they are also interested, not surprisingly, in improving their ability to address the causes and effects of the recent financial crisis. To be sure, the financial crisis has not prevented regulators from acting to advance a number of significant reforms, discussed below, that would benefit insurance companies by introducing new efficiencies to the regulation of insurance. For example, the adoption of principles-based reserving for life insurers, in lieu of formulaic reserve requirements, will mark a significant change in the regulation of life insurance in the United States. The NAIC's efforts to modernize reinsurance regulation, also discussed below, would mark a substantial shift in the regulatory regime, one that will have significant effects both on the business of insurance and on the structuring of transactions in the industry.

However, while the recent financial crisis has added urgency to the pursuit of regulatory reforms, it has also made the task more complex. It is clear, for example, that recent stresses in the financial system have made regulators and legislators more cautious in their review of certain proposals for change. While regulators continue to work on reforms that would mitigate significant capital impairments suffered by insurers in recent months, they are taking care to ensure that the need for modernization is balanced properly with the ongoing imperative to ensure insurance company solvency. Regulators are focusing in particular on the role of rating agencies in the regulatory regime, holding a day-long hearing on the topic

during the Fall Meeting, and reviewing several proposals, discussed below, that relate directly to the impact of ratings on insurance company capital requirements. These discussions show that developing regulatory reforms will likely include not only capital relief for insurance companies, but also more fundamental changes to the insurance regulatory approach to capital requirements.

Similarly, the NAIC and state legislators are taking a considered, methodical approach to a proposal for a "National Insurance Supervisory Commission," discussed below, that would dramatically increase federal involvement in the regulation of insurance. Vigorous discussion of this topic at the Fall Meeting, and an address by U.S. Vice President Biden to the assembled regulators regarding national health care reform, show that the prospect of federal insurance regulation remains at the forefront of the NAIC's agenda.

In any event, the coming months will bring continued regulatory developments at the NAIC that are of significant importance to the insurance industry. We will continue to monitor these developments, and hope that the summaries below prove useful to you.

NAIC PROPOSAL FOR A "NATIONAL INSURANCE SUPERVISORY COMMISSION"

In advance of the Fall Meeting, reports in the media suggested that the NAIC is developing a proposal to create a "National Insurance Supervisory Commission" consisting of state insurance regulators. The commission would have authority under federal law to develop uniform regulatory standards. States failing to adopt particular standards would in certain cases risk preemption of local laws by the commission's national standards. Legislators and regulators engaged in a lively debate on the topic at the Fall Meeting and state legislators in particular expressed serious reservations regarding the proposal. As a next step, the NAIC will arrange a meeting of regulators and legislators to discuss the proposal in advance of the NAIC's 2009 Winter National Meeting to be held from December 5-8 in San Francisco, California (the "Winter Meeting"). Roger Sevigny, the NAIC President and New Hampshire Commissioner of Insurance, suggested that this interim meeting would likely occur in November.

REGULATION OF INSURANCE HOLDING COMPANY SYSTEMS

At the Fall Meeting, the Executive (EX) Committee (the "Executive Committee") approved model law development requests for the NAIC Insurance Holding Company System Regulatory Act (Model 440) (the "Model Holding Company Act") and the Insurance Holding Company System Model Regulation with Reporting Forms and Instructions (Model

450) (the "Model Holding Company Regulation"), allowing the Group Solvency Issues (EX) Working Group (the "Group Solvency Issues Working Group") to review and revise these models. Among other things, the Model Holding Company Act provides for regulatory oversight of various activities that take place within insurance holding company systems, including acquisitions of control of an insurer, transactions between an insurer and another affiliate, and the payment of dividends by insurers. The Model Holding Company Regulation includes forms that are submitted when affiliates within a holding company system enter into transactions (Form D notice) or by an entity acquiring partial or total control of an insurer (Form A notice).

Every U.S. state has an act and regulation based on or similar to the Model Holding Company Act or Model Holding Company Regulation. Since the Model Holding Company Act and Model Holding Company Regulation are already models that must be enacted or adopted by a state for the state to be accredited by the NAIC, if the amendments to these models adopted as part of this review process also become NAIC accreditation requirements, that may result in wide-scale enactment or adoption of these amendments by the states. In the requests for model law development, the Group Solvency Issues Working Group recognized that revisions "could be highly controversial with interested parties" and that finalizing and adopting proposed changes could take over a year.

The Group Solvency Issues Working Group has compiled a list of over 50 potential changes to the Model Holding Company Act and Model Holding Company Regulation, covering a wide range of topics. At the Fall Meeting, suggested changes submitted by the Nebraska, Texas and Illinois regulators were considered, including:

- requiring that an insurer provide 30 days prior notice to its domestic insurance department for the termination or amendment of previously approved agreements with affiliates;
- adding mandatory provisions that would need to be included in any agreement for cost sharing, services and management transactions between affiliates, and requiring that charges or fees in such agreements for services may only be at the actual cost if the current market rate exceeds actual cost;
- requiring filing and approval of all reinsurance agreements between affiliates, and modifications to such reinsurance agreements, regardless of size or financial impact; and
- increasing the regulator's power to examine, and access information relating to, affiliates of an insurer in order to better protect the capital and condition of the overall enterprise.

The Group Solvency Issues Working Group noted that they will continue to discuss these and additional proposed changes prior to the NAIC's Winter Meeting. The working group also explicitly recognized the need to provide interested parties with an opportunity to comment on the proposed revisions early in the process of amending the Model Holding Company Act and Model Holding Company Regulation.

CAPITAL AND SURPLUS RELIEF FOR LIFE INSURERS

In November 2008, the American Council of Life Insurers (the "ACLI") submitted a nine-part proposal to the NAIC, suggesting certain actions the NAIC could take to provide relief from conservative reserve and risk-based capital standards applicable to life insurers, life insurance policies and annuity contracts. During the Fall Meeting, the NAIC adopted four aspects of the proposal:

- adoption of new Actuarial Guideline 1C, providing that a recalculation of segments under Section 4B of the Valuation of Life Insurance Policies Model Regulation (Model 830) is not required for policies issued on a policy form filed for approval prior to January 1, 2010 that are subject to a company election to substitute the 2001 Preferred Class Structure Table for the 2001 CSO Mortality Table;

- revisions to the Valuation of Life Insurance Policies Model Regulation (Model 830) (known as "Regulation XXX"), removing certain artificial X factor restrictions from the deficiency reserve calculation;

- revisions to the Actuarial Opinion and Memorandum Regulation (Model 822), relating to disclosure in the regulatory asset adequacy issues summary; and

- revisions to the Model Regulation Permitting the Recognition of Preferred Mortality Tables for use in Determining Minimum Reserve Liabilities (Model 815), permitting use of the 2001 CSO Preferred Class Structure Table for the valuation of certain policies issued prior to January 1, 2007, with regulatory consent and provided certain conditions are met.

In addition, the Accounting Practices and Procedures Task Force and the Financial Condition (E) Committee ("E Committee") considered revisions to Statement of Statutory Accounting Principles 10 ("SSAP No. 10") to adjust limitations on the admissibility of deferred tax assets ("DTAs"). The ACLI originally proposed that the realization period be expanded from 1 year to 5 years and the current cap be expanded from 10% of adjusted

capital and surplus to 25%. At the Fall Meeting, the Accounting Practices and Procedures Task Force narrowly adopted a revised version of SSAP No. 10 with a realization period of 3 years and a cap of 15% of adjusted capital and surplus. These revisions would "sunset" after two years, and the effects of the adjustments would be further studied during that period.

Subsequently, at the E Committee meeting, a representative of the Virginia Bureau of Insurance moved that the E Committee not adopt SSAP No. 10 as revised and instead hold a joint conference call a week after the Fall Meeting with the Accounting Practices and Procedures Task Force and the Statutory Accounting Principles Working Group to discuss whether the revisions to SSAP No. 10 are consistent with regulatory objectives. A representative of the New York Insurance Department countered this motion, noting that the issue had been debated at length and that the industry has a pressing need for certainty. After a lengthy debate, the E Committee voted to adopt the revisions to SSAP No. 10, with representatives from Florida, Tennessee and Alaska voting against adoption. The E Committee, Statutory Accounting Principles Working Group and Accounting Practices and Procedures Task Force have scheduled a joint conference call on October 8, 2009 to discuss the adopted revisions to SSAP No. 10. These revisions will be considered further by all members of the NAIC either during a plenary session at the Winter Meeting or on a conference call to be held in advance of the Winter Meeting.

The proposed revisions to SSAP No. 10 are particularly important for insurers domiciled or licensed in New York. Unlike other state insurance regulators, the New York Insurance Department may not revise the current realization period or cap by means of a prescribed or permitted practice or regulation. Under New York law, unless the NAIC revises the accounting practices and procedures manual to modify the treatment of DTAs, legislation would be required to implement revisions to the realization period or cap. In contrast, if the NAIC revises SSAP No. 10, the New York Superintendent may implement such revisions by regulation.

PRINCIPLES-BASED RESERVING FOR LIFE INSURERS

At the Fall Meeting, the NAIC adopted a revised version of its Model Standard Valuation Law (the "SVL") that would implement a new principles-based approach to life insurance and annuity reserves.

For over 150 years, states have regulated life insurance reserves using a relatively rigid, formulaic approach. Currently, the SVL mandates the use of static formulas for the calculation of reserves for most life insurance and annuity products, with prescribed mortality and interest rates. The SVL is based on a legislative model that has not changed

significantly since its inception in the mid-1800s. In the meantime, life insurance products and underwriting methods have advanced significantly. The new SVL would permit minimum required reserves based on modern principles of risk analysis and stochastic modeling. Unlike formulaic reserves, which are calculated based on standard mortality tables and other prescribed assumptions without consideration of an individual company's experience, the new SVL would base reserve calculations in part on assumptions formed after an analysis of relevant company data, and would require life insurers to submit company-specific mortality, morbidity, policyholder behavior, expense experience and other similar data to regulators. Before it takes effect in a particular state, the new SVL will need to be enacted by the state legislature. New York and Wisconsin are the only states that voted against adopting the new SVL at the Fall Meeting.

While the SVL includes general guidelines for the selection of reserve assumptions, risk analysis methods, margins for uncertainty and other factors for use in the establishment of principles-based reserves, much of the detail of the new requirements, including the specific company reporting requirements, will be set forth in a valuation manual that is still under development by the NAIC, and is targeted for completion by the end of 2009. The valuation manual is envisioned as the reserving analogue to the NAIC's *Accounting Practices and Procedures Manual*, and is intended to improve the ability of regulators to adapt reserving requirements to the evolving business practices of life insurers. The new SVL would permit states, where possible, to follow the requirements of the valuation manual as amended each year by the NAIC without having to adopt new legislation or regulations. State legislators and regulators would retain the power to alter any requirements in the valuation manual that the legislators or regulators believe are not in compliance with the new SVL. In addition, the new SVL explicitly permits a state regulator to require an insurer to change any assumption or method that the regulator believes is necessary to comply with the new SVL or the valuation manual.

Under the terms of the new SVL, principles-based reserving will take effect on January 1 of the first calendar year following the first July 1 as of which all of the following have occurred: (1) the valuation manual is adopted by the NAIC by a vote of the greater of 75% and 42 of the NAIC's member insurance commissioners, (2) the new SVL, or substantially similar legislation, is enacted by states representing more than 75% of the direct life and health premium written in 2008, and (3) the new SVL, or substantially similar legislation, is enacted in at least 42 U.S. jurisdictions. Principles-based reserving, once effective, will apply prospectively to business written by life insurers after the effective date, but will not apply retroactively to reserves on existing blocks of business. Currently existing reserve requirements will continue to apply to policies that are already in force on the effective date and, for certain types of products, the valuation manual may initially incorporate existing

reserving requirements. The process of legislative enactment is expected to take several years.

RESIDENTIAL MORTGAGE-BACKED SECURITIES HELD BY LIFE INSURERS

At the Fall Meeting, the Valuation of Securities (E) Task Force (the "Valuation of Securities Task Force") and the Capital Adequacy (E) Task Force (the "Capital Adequacy Task Force") discussed a revised and expanded proposal by the ACLI to address the impact of rating agency downgrades of residential mortgage-backed securities ("RMBS") on life insurer risk-based capital ("RBC") and improve the process of determining RBC by more accurately measuring the severity of losses on RMBS. RBC charges for RMBS are determined based on the NAIC designations assigned to the RMBS, which are currently based on the ratings assigned to RMBS by Nationally Recognized Statistical Rating Organizations ("NRSROs").

As explained in the ACLI proposal, NRSROs rate RMBS using a first dollar ratings methodology, where ratings are based on the likelihood of losses, but often fail to properly account for the severity of losses. To address this perceived shortcoming, the ACLI previously suggested that the NAIC increase NAIC-assigned ratings for certain structurally senior RMBS to a level that exceeds the applicable NRSRO rating. This proposal was reviewed by the Capital Adequacy Task Force and the Valuation of Securities Task Force at the NAIC's 2009 Summer National Meeting and during conference calls of the Valuation of Securities Task Force following the meeting.

Prior to the Fall Meeting, the ACLI revised the proposal to recommend that the NAIC's Securities Valuation Office engage a third party valuation firm to model losses on RMBS on a security-by-security basis based on assumptions used by market participants for prepayments, home price levels, expected defaults, severity of loss and performance of loans in good standing, as well as other assumptions. Insurance companies would then calculate the expected loss for each RBMS from a formula proposed by the ACLI, and the NAIC designation for the RMBS would be determined based on the expected loss. If a particular security has not been modeled, the ACLI offered two alternative approaches for determining the NAIC rating: (1) use of a company or third party model attested to by an officer of the insurer responsible for modeling, and application of the expected loss formula to the results of the model, or (2) use of an expected loss metrics methodology on a pool-by-pool basis based on existing delinquencies, multiplied by an estimated severity factor.

The Valuation of Securities Task Force expects to continue discussion of the ACLI proposal over the coming months.

STATUTORY ACCOUNTING TREATMENT OF INSURER INVESTMENTS IN RE-REMICS

The NAIC's Emerging Accounting Issues Working Group has recently been engaged in a review of accounting issues relating to re-securitizations of real estate mortgage investment conduits ("Re-REMICs"). A real estate mortgage investment conduit, known as a "REMIC," is a type of structured investment in which cash flows from an underlying pool of mortgage-related collateral are separated into different classes, each supporting a separate, tradable security.

During the financial crisis, REMICs and other structured securities based on residential and commercial mortgage cash flows have suffered from severe impairments. These impairments have affected securities that were viewed as highly secure when originally issued, and therefore carried high ratings when purchased by insurance companies and other investors. A Re-REMIC is a restructuring intended to mitigate the effects of these impairments. In a Re-REMIC transaction, cash flows from the underlying mortgage collateral are separated into a new set of classes. In the Re-REMIC, the subordinated classes in a structure are often enlarged in order to enhance the credit quality of senior classes that have a priority claim on cash flows from the collateral. This structural enhancement results in better ratings for the senior classes and, as a result, reduced capital charges. The advantages of a Re-REMIC are driven in particular by NRSRO ratings methodologies. As described in the section above regarding life insurer RMBS, these methodologies base ratings on the likelihood of loss, but may fail to properly account for loss severity. Ideally, a Re-REMIC will restructure the classification of mortgage cash flows in a manner that permits for a distribution of ratings that is more closely aligned with expected loss severities.

Prior to the Fall Meeting, the Emerging Accounting Issues Working Group exposed for comment INT 09-07, a tentative interpretation that would govern the statutory accounting treatment by insurers of investments in Re-REMICs. INT 09-07 is intended to cover transactions in which structured securities on an insurer's balance sheet are used in a Re-REMIC, and the insurer purchases some or all of the new securities issued from the Re-REMIC for its own account. INT 09-07 attracted comments from a number of interested parties and was the subject of extended discussion by the Emerging Accounting Issues Working Group at the Fall Meeting, with a focus on the extent to which Re-REMICs should be treated as a sale or a related party transaction under statutory accounting principles. In comments, industry participants expressed concern that INT 09-07 mischaracterizes the purpose and effect of Re-REMICs, and would inhibit ongoing efforts by insurers to restructure impaired mortgage-related investments.

In a divided vote, the Emerging Accounting Issues Working Group rejected a motion to adopt INT 09-07 as final. The working group exposed an alternative industry proposal for comment, and plans in the coming months to continue its consideration of accounting issues raised by insurer investments in Re-REMICs.

MODERNIZATION OF REINSURANCE REGULATION

During a conference call held prior to the Fall Meeting, the Reinsurance (E) Task Force (the "Reinsurance Task Force") adopted a final version of the Reinsurance Regulatory Modernization Act of 2009 (the "Modernization Act"). The Modernization Act is draft federal legislation that is part of a detailed reinsurance regulatory modernization framework proposal adopted by the NAIC in 2008 (the "Modernization Proposal"). The Modernization Proposal would represent a comprehensive reform of the U.S. reinsurance regulatory framework, providing for: (1) entry into mutual recognition agreements with non-U.S. jurisdictions; (2) regulation of a U.S. reinsurer by a single U.S. "home state supervisor;" and (3) regulation of a non-U.S. reinsurer by a single U.S. "port of entry supervisor." In order to effect these changes, the Modernization Proposal, in its original form, contemplated the creation of a new NAIC department, the NAIC Reinsurance Supervision Review Department consisting of state insurance commissioners.

In recent months, the Reinsurance Task Force has been reviewing concerns regarding the constitutionality of the Modernization Proposal, including aspects of the proposal that would permit states to enter into cooperation and information-sharing agreements with non-U.S. jurisdictions, and has revised the Modernization Act in an attempt to address these concerns. As revised, the Modernization Act proposes establishing the Reinsurance Supervision Review Board (the "RSRD") as an agency of the United States, with a supervisory board consisting of (1) ten state insurance commissioners, nominees for which would be submitted to the U.S. President by the NAIC, and (2) five directors appointed by the U.S. President from the Department of Treasury, the Department of Commerce and the Office of the United States Trade Representative (the "Board").

Under the proposed Modernization Act, the RSRD would have the authority to:

- evaluate the reinsurance supervisory systems of states to determine whether such jurisdictions qualify as "home state supervisors" or "port of entry supervisors" under standards recommended by the NAIC and adopted by the Board;

- evaluate the reinsurance supervisory systems of non-U.S. jurisdictions to determine whether they are eligible for recognition by the Board as "qualified non-U.S. jurisdictions" under standards recommended by the NAIC and adopted by the Board;
- develop sample supervisory recognition agreements and information sharing and regulatory cooperation agreements, to be entered into uniformly by "port of entry supervisors" with "qualified non-U.S. jurisdictions" under standards recommended by the NAIC and adopted by the Board; and
- preserve the confidentiality of supervisory information within the Board's control, and enter into agreements with state, federal, and non-U.S. financial supervisory and law enforcement officials and agencies for sharing supervisory information on a confidential basis.

At the Fall Meeting, the Reinsurance Task Force presented the Modernization Act to the NAIC's Government Relations Leadership Council (the "GRLC"), which accepted the Modernization Act without discussion. In order to implement the Modernization Act, the GRLC will attempt, in the coming months, to identify members of Congress to sponsor and introduce the Modernization Act.

Implementation of the Modernization Proposal will require the development of model state legislation for states that wish to become a "point of entry" supervisory state or "home state" as described in the Modernization Proposal. The Reinsurance Task Force noted at the Fall Meeting that work on this model state legislation will now begin.

REGULATION OF ANNUITY SALES

The Annuity Disclosure (A) Working Group (the "Annuity Disclosure Working Group") was charged in 2008 to consider changes to the NAIC Annuity Disclosure Model Regulation (the "Model Disclosure Regulation") in order to improve the disclosure of information provided for annuity products and to provide insurers with uniform guidance on developing disclosure practices and monitoring the distribution of annuities. During the Fall Meeting, the Annuity Disclosure Working Group continued its work on this topic, focusing on the content of required disclosures regarding insurance guaranty fund coverage and proposed guidelines for the preparation of annuity illustrations. In addition, the working group exposed three draft buyer's guides for comment - one to cover fixed annuities, a second to cover fixed indexed annuities and a third to cover variable annuities. Under the Model Disclosure Regulation, insurers would be required to make the relevant buyer's guides

available to prospective annuity purchasers in connection with the purchaser's submission of an application.

Additionally, at the Fall Meeting, the Suitability of Annuity Sales (A) Working Group continued its discussion of proposed revisions to the Suitability in Annuity Transactions Model Regulation ("Model Suitability Regulation"). Prior to the Fall Meeting, the working group exposed a revised draft of this model regulation and received comments from a number of interested parties. Several interested parties suggested that regulators should not pursue changes to the Model Suitability Regulation, but should instead seek to achieve enactment of the existing model regulation in a greater number of states, and to improve enforcement and clarify interpretation of regulations that are already on the books. In support of this approach, interested parties proposed a model interpretive bulletin that could be issued by individual state insurance departments. However, during the Fall Meeting, the working group voted to reject any approach that would involve only the development of a model bulletin or other similar interpretive guidance, and committed to continue the pursuit of revisions to the Model Suitability Regulation. The working group agreed to accept further comments on the proposed revisions to the Model Suitability Regulation within the next few weeks, and plans to schedule a conference call in October to discuss these comments.

If you would like more information on these or other topics of interest, please contact the undersigned or any insurance industry lawyer at Debevoise & Plimpton LLP.

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