NAIC 2009 WINTER NATIONAL MEETING

December 11, 2009

To Our Clients and Friends:

The National Association of Insurance Commissioners (the "NAIC") held its 2009 Winter National Meeting (the "Winter Meeting") from December 5 to 8, 2009, in San Francisco, California. This Client Update highlights some of the developments from the Winter Meeting that are of particular interest to many of our insurance industry clients, including developments relating to: (1) regulation of insurance holding company systems, (2) treatment of deferred tax assets, (3) accounting treatment for residential mortgage-backed securities, (4) alternative mechanisms for restructuring troubled insurers, (5) principle-based reserving for life insurers, (6) regulation of annuity sales and (7) insurer investments in Iran.

REGULATION OF INSURANCE HOLDING COMPANY SYSTEMS

At the NAIC's 2009 Fall National Meeting (the "Fall Meeting"), 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 control of an insurer (Form A notice).

At the Winter Meeting, among other things, the Group Solvency Issues Working Group discussed draft revisions to the Model Holding Company Act and Model Holding Company Regulation. Notable additions to the Model Holding Company Act include (1) new reporting obligations for holding company systems that include an insurer, (2) authorization for the state insurance commissioner to examine an insurer's affiliates for risk of "financial contagion" to the insurer, (3) a new set of provisions required to be incorporated into agreements for cost-sharing services and management between an insurer and another entity

within its holding company system and (4) authorization for the commissioner to participate in "supervisory colleges" with other state, federal and international regulators to determine whether a particular insurer is in compliance with state insurance law. Because the draft was released only two weeks before the Winter Meeting, the Group Solvency Issues Working Group expects to receive additional feedback on the proposals and interested parties may continue to submit comments until January 29, 2010.

The Group Solvency Issues Working Group debated a proposal by the Connecticut Insurance Department (the "Connecticut Proposal") to include language in the Model Holding Company Act requiring that certain agreements between an insurer and its affiliate contain provisions stating that the insurer's board and management—rather than just the entity—will maintain oversight and responsibility for maintenance of internal controls and oversight of the affiliate's performance. Several members of the Group Solvency Issues Working Group spoke out against this proposal, arguing that it would unnecessarily alter the standard of care traditionally applied to directors and that it would be inappropriate to require board involvement in such a quintessentially managerial function, particularly since neither the draft nor the Connecticut Proposal contained a materiality qualifier for agreements covered. One working group member compared the Connecticut Proposal to a proposal that was considered and ultimately rejected in the course of the NAIC's development of corporate governance standards relating to principle-based reserving for life insurers. That proposal would have made board members directly responsible for oversight of policies related to the adequacy of an insurer's principle-based reserves, but was clarified (due in part to concerns that directors' responsibilities would be too uncertain) to state that a board's oversight would be general in character and to delineate the scope of a board's responsibilities regarding processes, infrastructure and documentation.

TREATMENT OF DEFERRED TAX ASSETS

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. As reported in our September 28, 2009, client update, at the Fall Meeting, the NAIC adopted four aspects of the proposal.

At the Winter Meeting, the NAIC narrowly adopted a fifth aspect of the ACLI proposal revisions to Statement of Statutory Accounting Principles 10 ("SSAP No. 10") to adjust limitations on the admissibility of deferred tax assets ("DTAs"). These revisions adjust limitations on the admissibility of DTAs by increasing the realization period from one to three years and increasing the percentage limitation from 10% of statutory capital and surplus to 15%. However, the changes explicitly require a statutory valuation allowance

adjustment to gross DTAs based on a more-likely-than-not threshold for realization (*i.e.,* a likelihood of more than 50%), and only insurers that are subject to risk-based capital requirements or are required to file a risk-based capital report with their domiciliary state are provided the option to admit additional DTAs. Moreover, these revisions will "sunset" by the end of 2010 and thus will be effective only for 2009 annual statutory financial statements and 2010 quarterly and annual statutory financial statements.

RESIDENTIAL MORTGAGE-BACKED SECURITIES HELD BY LIFE INSURERS

At the Winter Meeting, the Valuation of Securities (E) Task Force ("Valuation of Securities Task Force") placed residential mortgage-backed securities ("RMBS") under regulatory review. Risk-based capital charges for RMBS are determined based on the NAIC designations assigned to each security, which are currently based on the ratings assigned by nationally recognized statistical rating organizations ("NRSROs"). As a result of this review, for year-end 2009 reporting and until a long-term solution is implemented, the NAIC will not use credit ratings to determine risk-based capital for RMBS and instead will utilize a financial model developed by Pacific Investment Management Company to determine risk-based capital. NRSROs generally 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. In contrast, the third-party financial model to be used for year-end 2009 reporting will model RMBS on a security level basis using generally accepted assumptions for prepayments, home price levels, expected defaults, severities of loss and performance of loans in good standing. Re-securitizations of real estate mortgage investment conduits (Re-REMICs) will be similarly modeled.

ALTERNATIVE MECHANISMS FOR RESTRUCTURING TROUBLED INSURERS

During the Winter Meeting, the Financial Condition (E) Committee adopted without debate a white paper entitled "Alternative Mechanisms for Troubled Companies" (the "White Paper") on the emergence of alternatives to traditional receivership proceedings. The White Paper is the product of the Restructuring Mechanisms for Troubled Companies (E) Subgroup (the "Restructuring Mechanisms Subgroup"), which was charged with developing an understanding of (i) the current use and implementation of alternative mechanisms, (ii) the potential effect on claims of creditors and (iii) how alien insurers who have utilized these mechanisms might affect the solvency of domestic companies. The ultimate goal is development of best practices for supervision of troubled insurers outside of formal receivership.

The White Paper describes the operation of several alternative mechanisms and lists advantages and disadvantages of each. These mechanisms include run-off of a troubled company; commutation of reinsurance agreements under New York Insurance Law §1321 and Regulation 141; voluntary restructuring of solvent insurers under Rhode Island's Title 27, Chapter 14.5 and Insurance Regulation 68 (together, the "Rhode Island Provisions"); "schemes of arrangement" between a company and its creditors under Part 26 of the United Kingdom Companies Act; and transfer by one reinsurer to another of reinsurance business under Part VII of the UK's Financial Services and Markets Act 2000. During a November conference call, the Restructuring Mechanisms Subgroup reviewed comments from several corporate policyholders objecting to any implied endorsement of mechanisms that would permit solvent insurers to cut off the contractual rights of policyholders. As a result, the White Paper's discussion of the Rhode Island Provisions and the UK's schemes of arrangement now includes several additional "disadvantages" that did not appear in previous drafts.

The White Paper also discusses in general terms the statutory provisions for policyholder priority and voidable preferences under existing receivership statutes, the necessity of close supervision by regulators of alternative mechanisms and the ramifications for U.S. policyholders and creditors of the restructuring of foreign companies. Appendices include case studies illustrating some of the procedures discussed in the White Paper as well as sample documents.

PRINCIPLE-BASED RESERVING FOR LIFE INSURERS

At its 2009 Fall National Meeting, the NAIC adopted a revised Model Standard Valuation Law (the "SVL") that would implement a new principle-based approach to life insurance and annuity reserving. This new SVL abandons the traditional formula-based approach to calculation of reserves in favor of modern, experience-based stochastic modeling. While the SVL includes general guidelines for principle-based reserving, much of the technical detail of the new requirements, including specific company reporting requirements, is to be set forth in a valuation manual. Although an initial version of the valuation manual was scheduled to be finalized at the Winter Meeting, the Life and Health Actuarial Task Force ("LHATF") continues to develop certain key sections of the valuation manual, including VM-20 (Requirements for Principle-Based Reserves for Life Products) and VM-25 (Health Insurance Reserves Minimum Reserve Requirements). Consequently, LHATF requested, and the Life Insurance & Annuities (A) Committee (the "A Committee") granted, an extension of the deadline for completion of an initial version of the valuation manual to

August 2010, with the goal of presenting the new SVL to the states in time for adoption during their 2011 legislative sessions.

In a brief session at the Winter Meeting, the Principles-Based Reserving (EX) Working Group (the "PBR Working Group") of the Solvency Modernization Initiative (EX) Task Force reviewed comments to a draft memorandum to be submitted to the Executive Committee that would seek guidance on the prospect of the NAIC acting as statistical agent in the collection, analysis and storage of insurers' experience data. Studies of insurer experience are an essential component of a principle-based reserving regime. For this reason, the revised SVL requires insurers to submit mortality, morbidity, policyholder behavior or expense experience and other data, but leaves the details concerning the type and form of data required and with whom the data must be submitted to be specified in the valuation manual.

However, there is a lack of consensus among regulators and industry as to the purpose of data collection and the scope of the NAIC's role in the process. Larry Bruning of Kansas, who spoke on behalf of LHATF, argued that experience data should be used for more than developing industry-level information. In particular, regulatory actuaries need the ability to consider the assumptions used by individual companies in principle-based reserving in light of industry benchmarks, which would allow early identification of "outlier" companies that would become candidates for closer regulatory scrutiny. Therefore, regulators must be able to identify experience data to a particular company. The ACLI, on the other hand, emphasized that the purpose of collecting such data should be to develop industry-level reports, not to track individual company experience. If data were collected from all life insurers and identified to the submitting company, regulators could assess the validity of a company's assumptions without a full understanding of the reasons that a given company's experience might deviate from the industry average. Such collection would also impose a significant expense on smaller companies with little marginal increase in the value of industry-level reports. Therefore, the ACLI suggested that experience data be collected only from enough insurers to represent 75% of the life insurance industry—a relatively small number of companies—and that it be scrubbed of identifying information by the statistical agent and stored in aggregate format. Regulators should assess the appropriateness of company assumptions through direct communication with the insurer at issue. In addition, as the ACLI noted, as currently drafted, VM-50 (Experience Reporting Requirements) requires every insurer using principle-based reserving to explain its valuation methodology and the source of its data.

NAIC staff will revise the draft memorandum for further discussion by LHATF and additional public comment.

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. At the Winter Meeting, the Annuity Disclosure Working Group continued its work on these topics, focusing on the ACLI's Discussion Draft of Proposed Annuity Illustration Guidelines (the "Proposed Illustration Guidelines"). The Proposed Illustration Guidelines are intended to provide guidance to companies preparing pre-sales illustrations for fixed deferred annuities and would be incorporated as an appendix to the NAIC's Annuity Disclosure Model Regulation. The Proposed Illustration Guidelines would set forth information to be included in all illustrations, prescribe limitations on the maximum rate that may be illustrated and require a clear statement that an illustration does not constitute a guarantee of amounts to be paid out. As currently drafted, the Proposed Illustration Guidelines would apply only when a company chooses to use an illustration in marketing an annuity. However, at the Winter Meeting, certain interested parties argued that an illustration used in any sale of a product be used in all sales of that product. The Annuity Disclosure Working Group agreed to hold additional discussions on these issues and resolved to seek an extension of its charge from the A Committee.

Four days before the formal opening of the Winter Meeting, the Suitability of Annuity Sales (A) Working Group adopted a new Suitability in Annuity Transactions Model Regulation ("Model Suitability Regulation") for consideration by the A Committee. The revised regulation makes several significant modifications to the existing model regulation, including (1) adding a 12-part list of "suitability information" that a producer must seek from a consumer before making a recommendation, (2) imposing new training requirements on producers and (3) requiring insurers to establish robust procedures for monitoring compliance with the Model Suitability Regulation and placing ultimate responsibility on an insurer for its producer's failure to comply. The A Committee plans to discuss the Model Suitability Regulation during a December 18, 2009, conference call. In the interim, comments on the language and structure of the regulation, but not its substance, will continue to be accepted.

INSURER INVESTMENTS IN IRAN

In a speech at the Winter Meeting's Opening Session, California Insurance Commissioner Steve Poizner spoke about his ongoing efforts to require insurers licensed in California to divest from certain strategically important sectors in Iran. In June 2009, Commissioner

Poizner issued a data call pursuant to a 2008 state law that prohibits California insurers from holding direct investments in countries designated by the U.S. Secretary of State as state sponsors of terrorism. He reported total investment by such insurers in the Iranian banking, energy, nuclear and defense sectors (the "Relevant Sectors") of $12 billion, all in indirect holdings. Commissioner Poizner has announced his intention to issue a list of companies doing business in the Relevant Sectors; from that time, insurers will have 30 days to declare their intention to divest from those companies and 90 days to dispose of the relevant assets. Insurers that do not comply will be named on the website of the California Department of Insurance and insurers persisting in holding indirect investments in the Relevant Sectors, Commissioner Poizner warned, will be subject to legal action under his authority to order insurers to dispose of unsound assets. He has already announced plans to issue subpoenas to 10 insurers that failed to reply to the June data call.

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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