NAIC 2010 SPRING NATIONAL MEETING

April 5, 2010

To Our Clients and Friends:

The National Association of Insurance Commissioners (the "NAIC") held its 2010 Spring National Meeting (the "Spring Meeting") from March 24 to 28, 2010, in Denver, Colorado. This Client Update highlights some of the developments from the Spring Meeting that are of particular interest to many of our insurance industry clients, including developments relating to: (1) regulatory modernization; (2) the solvency modernization initiative; (3) the disclosure of corporate governance and compensation information; (4) the valuation of structured securities; (5) the treatment of deferred tax assets; (6) changes to the climate change risk survey; (7) alternative mechanisms for restructuring troubled insurers; (8) the suitability of annuity sales and (9) stranger-owned and stranger-originated annuities.

REGULATORY MODERNIZATION

Over the past year the NAIC has shown, on the whole, an increased interest in pursuing comprehensive regulatory reform in the wake of the financial crisis. Perhaps the most notable evidence of this interest was the release of a discussion draft in advance of the September, 2009 national meeting of the NAIC that contemplated the establishment, by an act of the U.S. Congress, of a "National Insurance Supervisory Commission" comprised of state insurance regulators. The Commission would have authority under federal law to develop a broad array of national regulatory standards that would bind the states. These national standards would cover topics that, in the NAIC's words, are "appropriate for nationally uniform treatment." According to the discussion draft, the national standards to be developed by the Commission would potentially govern the regulation of producer and company licensing, product review and approval, surplus lines, market conduct, financial surveillance, reinsurance and receivership. National standards on these topics would be developed through existing NAIC mechanisms, and would continue to be implemented and enforced by state insurance regulators. In a sense, this proposal would establish the NAIC as a quasi-federal insurance regulator.

The discussion draft contemplates dividing the states into three tiers. A "tier one" state would be one that has enacted a state law that automatically gives all of the Commission's standards the full force of law within the state, as and when promulgated by the Commission, without any further state legislative action. A "tier two" state would be one that is unable to enact such a state law because of "constitutional or other legal impediments." For example, some state constitutions may prohibit the automatic adoption of Commission standards as an impermissible delegation of rule-making powers to an entity that is not an agency of that state. In a "tier two" state, the state legislature or insurance regulatory authority would need to adopt each Commission standard separately. In this way, the process in "tier two" states would resemble the process that exists today. In order to implement NAIC model laws and regulations, a state currently must enact new legislation or promulgate a new set of regulations based on the NAIC model. Finally, a "tier three" state would be one that has failed to adopt Commission standards, whether automatically or pursuant to separate legislation or regulations.

Any "tier three" state that has failed to implement a Commission standard will risk preemption of local laws by the Commission's national standards. According to the discussion draft, if a state ignores a Commission standard, the new federal "Office of National Insurance" or "Office of Insurance Information" contemplated by various congressional financial reform proposals would implement the relevant Commission standard, preempting state law. The discussion draft proposes limits on this federal preemption authority that would narrowly constrain any federal regulatory action to the subject matter of the specific Commission standard that needs to be implemented in the relevant "tier three" state.

In addition to responsibility for the development of national standards, the discussion draft proposes several other important roles for the Commission. Among other things, the Commission would serve as the "insurance sector representative for purposes of systemic risk regulation," and would have a role participating in any financial oversight or similar council of financial regulators established by federal financial reform legislation currently under consideration in the U.S. Congress. In addition, the Commission would "participate directly and equally with federal functional regulators engaged in international trade or commercial negotiations."

Notably, although the discussion draft would preserve a prominent role for the NAIC and state insurance regulators, it would significantly diminish the power and influence of state legislators over the regulation of insurance. While the discussion draft would establish a committee of state legislators to make recommendations to the Commission, it proposes giving state legislators nothing more than an advisory role. Not surprisingly, state legislators have objected strenuously to this aspect of the NAIC's proposal.

During its September 2009 national meeting, and at a subsequent public forum in December of 2009, consumer advocates and state legislators expressed serious reservations about the discussion draft, strongly criticizing both the substance of the proposal and the transparency of the NAIC's deliberations. In a December 2009 letter to the NAIC, the National

Conference of Insurance Legislators indicated to the NAIC that it has "grave and fundamental concerns with the substance, process, and politics" of the proposal, and criticized the NAIC for its "willingness to turn [its] back on the state-based system and join with the federal government to secure a seat at the proverbial table . . . ."

At the Spring Meeting, the NAIC established a new Regulatory Modernization (EX) Task Force in order to formalize and continue deliberations regarding the proposed National Insurance Supervisory Commission and similar comprehensive reform proposals. At the meeting, the new task force clearly signaled a cautious approach, striking a conciliatory tone and stressing the need for consensus among state regulators, state legislators and other interested parties. No definitive action was taken, and the task force received testimony from several state legislators and industry representatives regarding the existing insurance regulatory regime and potential approaches to regulatory modernization.

The charges of the new task force are diffuse, and do not promise definitive action in the near future. Among other things, the task force is charged with developing "a plan for building member consensus and necessary constituency support for national uniformity in areas that will enhance the existing strengths of state insurance regulation." Still, the establishment of the task force indicates that the NAIC will continue to pursue the idea of comprehensive reform, and is mindful of the continuing potential for fundamental changes to the landscape of insurance regulation as a result of ongoing efforts to enact federal financial reform legislation. In particular, the charges of the new task force demonstrate that the NAIC will continue to consider the idea of a federally sponsored commission of state regulators. According to its charges, the task force will "[c]ontinue to seek input, revise and refine the National Insurance Supervisory Commission discussion draft as a viable strategy for a national system of state-based regulation." Clearly, the task force's activities bear watching at future meetings.

SOLVENCY MODERNIZATION INITIATIVE

The NAIC's solvency modernization initiative, announced in June of 2008, is aimed at crafting recommendations to improve the U.S. solvency framework and spans a variety of NAIC reform projects. To this end, the Solvency Modernization Initiative (EX) Task Force (the "SMI Task Force") met at an interim meeting held in Phoenix, Arizona on March 11-12 (the "Interim Meeting") and again at the Spring Meeting to discuss various aspects of the initiative, including regulatory capital requirements, group solvency surveillance, international solvency efforts, accounting standards and corporate governance.

At the Interim Meeting, the SMI Task Force discussed its consultation paper regarding regulatory capital. Among other things, the SMI Task Force is considering modifications to risk-based capital factors, changes to how risks are measured and which risks are considered (such as catastrophe risk), and recalibration of the risk-based capital formula. The SMI Task Force's deliberations and requests for comments suggest that it is unlikely that economic capital requirements will displace risk-based capital regulation as a central regulatory tool. There is recognition that well-run companies have their own economic capital considerations and that these are distinct from regulatory calculations: risk-based capital was intended to be a floor for triggering regulatory intervention and not a standard for economically desirable capitalization. Instead of displacing risk-based capital, the SMI Task Force's efforts have been focused on improving risk-based capital analysis and expanding the information available to such analysis. There is, however, interest in supplementing risk-based capital regulation with some tools used internationally, such as the Own Risk and Solvency Assessment ("ORSA"), a recently-developed European Union method for internal risk and capital assessment.

As noted at the Interim Meeting by Director Urias of Arizona, chair of the SMI Task Force, the financial crisis has highlighted certain unsafe business practices and regulators are increasingly becoming aware of the roles of corporate governance and risk management in maintaining the financial solvency of regulated companies. Director Urias also suggested that state insurance regulators should have the explicit authority to enforce corporate governance requirements and to take action when they believe such requirements have not been met. Depending on the scope of any such enforcement rights, this could represent a fundamental shift in the corporate governance framework and could impose significant new potential liabilities on directors and executive officers. The corporate governance working group of the SMI Task Force has, however, recognized the importance of avoiding conflicts with existing corporate governance requirements under state law. To this end, the working group plans to review the existing legal framework in at least several states at the outset of its review.

The question of accounting standards will be taken up by a new Statutory Accounting and Financial Reporting Subgroup, with commissioner-level participation, which will "recommend the future of U.S. statutory accounting and financial reporting." At the Interim Meeting, the SMI Task Force discussed its consultation paper on regulatory capital requirements and accounting and valuation issues. With respect to accounting and valuation issues, the SMI Task Force is considering, among other things, the possibility of using Financial Accounting Standards Board and International Accounting Standards Board accounting standards as an alternative to continuing with U.S. statutory accounting practices.

At and prior to the Spring Meeting, the SMI Task Force and its Group Solvency Issues (EX) Working Group (the "Group Solvency Working Group") have been considering various proposed revisions to 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"). 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 its affiliates and the payment of dividends by insurers. The Model Holding Company Regulation includes forms to be submitted, for example, when affiliates within a holding company system enter into transactions (Form D notice) or prior to the acquisition of control of an insurer (Form A notice). The proposed revisions 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 cost-sharing and management agreements 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. Not surprisingly, these proposed revisions have generated significant comment and discussion among regulators and interested parties. It is expected that the Group Solvency Working Group will continue to focus on the Model Holding Company Act and Model Holding Company Regulation in the coming months.

DISCLOSURE OF CORPORATE GOVERNANCE AND COMPENSATION INFORMATION

At the Spring Meeting, the NAIC/AICPA working group announced its intention to consider adopting new insurance regulations based on recent amendments by the U.S. Securities and Exchange Commission (the "SEC") to the proxy disclosure rules applicable to public companies. The SEC's recent amendments are contained in SEC Release No. 33-9089[1] and would, among other things, require disclosure in a company proxy statement of:

- the effect on risk management and risk-taking incentives of compensation policies and practices that are "reasonably likely to have a material adverse effect" on the company;

1 *See http://www.sec.gov/rules/final/2009/33-9089.pdf*.

- the "specific experience, qualifications, attributes or skills" that led to the conclusion that all continuing directors and director nominees should serve on the company's board of directors;
- the "leadership structure" of the board of directors, including a discussion of whether and why the company has chosen to combine or separate the positions of chairman of the board and chief executive officer;
- the role of the board of directors in the oversight of risk; and
- the role of diversity in evaluating director candidates.

The foregoing list is not exhaustive. Because the NAIC/AICPA working group's review of this matter is at a preliminary stage, it is unclear what elements of the recent SEC amendments might be incorporated into any proposed new insurance regulations, or if the working group might consider adopting other elements of the proxy disclosure rules that predate the recent SEC amendments. If the working group moves forward with this proposal, it will represent a significant new burden for some insurers. For example, if adopted, new regulations based on the new proxy disclosure rules presumably would apply to insurers, such as mutual companies, that would not otherwise be subject to federal securities laws and regulations affecting public companies. These new regulations could be implemented in a manner similar to the recent revisions to the NAIC's Annual Financial Reporting Model Regulation (also known as the "Model Audit Rule"). The Model Audit Rule recognizes that publicly-traded companies are subject to their own governance requirements including a requirement of the Sarbanes-Oxley Act that they have an audit committee composed of independent directors. To avoid multiple layers of governance requirements, although the Model Audit Rule is applicable to insurers generally, if a parent holding company has an audit committee composed of independent directors, then the parent's audit committee can act as the audit committee of a subsidiary insurer for purposes of the Model Audit Rule, and the subsidiary is not required to reconstitute its board in order to establish a subsidiary audit committee composed of independent directors.

As a next step, the working group has asked NAIC staff to create a discussion draft setting forth an approach to the implementation of new insurance regulatory disclosure rules, and plans to schedule a conference call to solicit feedback on the discussion draft from the insurance industry and other interested parties.

VALUATION OF STRUCTURED SECURITIES

As we reported in our December 11, 2009 Client Update, available at www.debevoise.com, at the December 2009 national meeting of the NAIC, the NAIC determined not to use credit ratings assigned by nationally recognized statistical rating organizations ("NRSROs") in the year-end 2009 determination of risk-based capital calculations applicable to non-agency residential mortgage-backed securities ("RMBS"). Instead, with limited exceptions to account for the scarcity of data for particular securities, the NAIC decided to use an alternative financial model developed by Pacific Investment Management Company ("PIMCO") on the NAIC's behalf. NRSROs generally rate RMBS using a first dollar ratings methodology, where ratings are based on the likelihood of losses, but arguably fail to properly account for the severity of losses. In contrast, the PIMCO model analyzed non-agency RMBS on a security level basis using generally accepted assumptions for prepayments, home price levels, expected defaults, severity of loss and performance of loans in good standing. PIMCO similarly modeled re-securitizations of real estate mortgage investment conduits (Re-REMICs).

At the Spring Meeting, the NAIC's Valuation of Securities (E) Task Force (the "VOS Task Force") commented on the success of the PIMCO modeling project and received several laudatory comments from interested parties. During the meeting, the VOS Task Force decided to continue the use of the non-agency RMBS modeling process for future periods, until a more comprehensive solution for the valuation of all loan-backed and structured securities is fully developed and implemented. Going forward, modeling for non-agency RMBS would take place semi-annually, if technically feasible.

The VOS Task Force also continued its discussion of a long-term solution for the valuation of all loan-backed and structured securities. During the meeting, the VOS Task Force adopted a recommendation to implement, effective December 31, 2010, an independent modeling process for an additional array of loan-backed and structured securities. In making its recommendation, the VOS Task Force noted that it cannot control or observe a number of aspects of the NRSRO rating methodology, including the timing of rating reviews and the consistency among different NRSROs of applicable assumptions. According to the VOS Task Force, "[i]n using modeling, the NAIC keeps control of the timing, assumptions, data, and economic scenarios. As a result, the NAIC designations will be more accurate at any given point in time (as long as the quality of the analysis is at least as high as that done by the [NRSROs])." The views of the VOS Task Force are indicative of a developing consensus among insurance regulators in favor of de-emphasizing the role of NRSROs in the insurance regulatory framework.

The modeling process contemplated by the VOS Task Force would be analogous to the process employed at year-end 2009 for non-agency RMBS, and would also apply to commercial mortgage-backed securities, asset-backed securities and other classes of structured securities where the NAIC determines that modeling can be made applicable and is cost-effective. The NAIC would continue to employ valuation methodologies linked to ratings assigned by NAIC-approved NRSROs in the case of structured securities that are not modeled.

All recommendations of the VOS Task Force were adopted by the NAIC's Financial Condition (E) Committee at the Spring Meeting.

TREATMENT OF DEFERRED TAX ASSETS

The Capital Adequacy (E) Task Force gave a brief update on the progress of the work that it has undertaken to analyze the treatment of deferred tax assets ("DTAs"). As discussed in our December 11, 2009 Client Update, available at www.debevoise.com, at the December 2009 national meeting of the NAIC, the NAIC adopted revisions to Statement of Statutory Accounting Principles No. 10 to adjust limitations on the admissibility of 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, these revisions will "sunset" by the end of 2010 and thus will now be effective only for 2010 quarterly and annual statutory financial statements. A report on the analysis of the effects of the change in the admissibility of DTAs will be given to the task force in June, 2010 and a full report is expected to be exposed in September, 2010.

CHANGES TO THE CLIMATE RISK SURVEY

Amid much debate, the NAIC narrowly adopted a revised version of its Insurer Climate Risk Disclosure Survey (the "Climate Survey"). The Climate Survey contains a set of eight questions posed to insurers to help regulators assess insurers' risk assessment and management efforts regarding climate change. The Climate Survey was originally adopted at the NAIC 2009 Spring National Meeting, following extensive discussion, debate and compromise among regulators, consumer advocates and industry representatives.

Although the revised version of the Climate Survey adopted at the Spring Meeting delineates the same eight questions as that adopted in 2009, it nonetheless reflects certain significant changes from the 2009 version. In particular, language was added:

- providing that survey responses are confidential and that participating states are to coordinate with the NAIC to develop a public report;

- emphasizing that "requirement for completion" of the Climate Survey is at the discretion of each state;

- indicating that the Climate Survey does not express any opinion on the existence or absence of climate change; and

- providing that participation in the Climate Survey will not be considered for any purpose relating to regulatory consideration of an insurer's proposed rate change.

Given the controversy surrounding the adoption of the revised Climate Survey, it is unclear whether states will use the survey as adopted or modify it to suit their preferences. For example, states which opposed the confidentiality provision may implement the survey without any such protection. Furthermore, it is possible that a state or states could require all licensed companies, rather than just domestic insurers, to complete the survey and therefore effectively implement a particular version of the survey on a nationwide basis.

ALTERNATIVE MECHANISMS FOR RESTRUCTURING TROUBLED INSURERS

At its plenary session during the Spring Meeting, the NAIC unanimously adopted a white paper entitled "Alternative Mechanisms for Troubled Companies" (the "White Paper") on the emergence of alternatives to traditional receivership proceedings. The White Paper has been under development for some time, and is the product of the Restructuring Mechanisms for Troubled Companies (E) Subgroup (the "Restructuring Mechanisms Subgroup"), which was charged with developing an understanding of (1) the current use and implementation of alternative restructuring mechanisms, (2) the potential effects of such mechanisms on the claims of creditors and (3) the effects of alien insurers that use these mechanisms on the solvency of domestic companies. The White Paper is intended as a source of guidance to state insurance regulators who may need to assess possible alternatives for troubled insurance companies from time to time.

The White Paper describes the operation of several alternatives to receivership 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; "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.

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 restructuring mechanisms and the ramifications for U.S. policyholders and creditors of the restructuring of non-U.S. companies. Appendices include case studies illustrating some of the procedures discussed in the White Paper as well as sample documents.

For further discussion of alternative approaches to restructuring troubled insurers, including a description of the White Paper, see the article on restructuring troubled insurers in the March, 2010 issue of the *Debevoise & Plimpton Financial Institutions Report*, available at www.debevoise.com.

SUITABILITY OF ANNUITY SALES

In its plenary session at the Spring Meeting, the NAIC unanimously voted to adopt a revised version of its Suitability in Annuity Transactions Model Regulation (the "Model Suitability Regulation"). According to the NAIC, the revisions are intended to "strengthen the model's provisions to better protect consumers from inappropriate and abusive marketing practices." The revisions resulted from an extensive review and discussion among regulators and other interested parties that lasted the better part of two years.

Notably, the revised Model Suitability Regulation includes a clear statement that an insurer issuing annuities will be responsible, in all cases, for compliance with the terms of the regulation, including in cases where the insurer subcontracts with independent producers or other third parties in connection with the sale and distribution of annuity products. This feature of the model places a heavy burden on insurers to ensure that all of their producers comply strictly with the regulation in order to avoid regulatory penalties. The revised model makes several other significant modifications, including:

- the addition of a 12-part list of "suitability information" that must be sought from a consumer before a recommendation is made to the consumer to purchase, exchange or replace an annuity;
- the addition of specific suitability criteria that an insurer or producer must reasonably believe are satisfied in order to make a recommendation, including that the consumer is "reasonably informed" of the features of the annuity, that the consumer would benefit from features of the annuity, and that the transaction is "suitable" in light of the consumer's "suitability information;"

- new training requirements for producers;
- a new provision that prohibits producers from dissuading or attempting to dissuade a consumer from responding truthfully to an insurer's request for confirmation of "suitability information," from filing a complaint with regulatory authorities or from cooperating with the investigation of a complaint; and
- new, detailed provisions that require insurers to establish specific procedures to supervise producers in order to ensure compliance with the regulation.

Now that it has been adopted by the NAIC's plenary, the revised model will be considered for adoption in individual states. Proposed NAIC model acts and regulations and changes to existing models become binding in a state as and when they are enacted into law by the state legislature or promulgated as regulations by the state's insurance regulator.

STRANGER-OWNED AND STRANGER-ORIGINATED ANNUITIES

At the Spring Meeting, the Life Insurance and Annuities (A) Committee (the "A Committee") adopted its 2010 charges, which include a new charge to "explore the issue" of stranger-owned and stranger-originated annuities. Under the new charge, the A Committee will review the interaction of transactions involving stranger-owned and stranger-originated annuities with "insurable interest" laws. In the context of life insurance products, insurable interest laws generally require that a policyholder have a meaningful interest in the continued life of the person insured. In New York, for example, a policyholder must have "a substantial interest engendered by love and affection" or "a lawful and substantial economic interest" in the continued life of the insured.[2] The A Committee will also consider whether it should pursue potential revisions to the NAIC Viatical Settlements Model Act or a new model law or regulation in order to strengthen consumer protections in this area.

In addition, the NAIC announced a public hearing to take place on May 20 in Washington, D.C. to discuss the emergence of stranger-owned and stranger-originated annuities. According to the NAIC, the hearing "will focus on the suspect practice of targeting seniors and terminally ill patients by inducing them to purchase an annuity largely for the benefit of investors or intermediaries."

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2 *New York Insurance Law § 3205*.

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.

Wolcott B. Dunham, Jr.
+1 212 909 6595
wbdunham@debevoise.com

Nicholas F. Potter
+1 212 909 6459
nfpotter@debevoise.com

John Dembeck
+1 212 909 6158
jdembeck@debevoise.com

Elizabeth K. Brill
+1 212 909 6945
ebrill@debevoise.com

Michael K. McDonnell
+1 212 909 6298
mmcdonnell@debevoise.com

Derek P. Alexander
+1 212 909 6021
dalexander@debevoise.com