NAIC 2010 FALL NATIONAL MEETING

November 3, 2010

To Our Clients and Friends:

The National Association of Insurance Commissioners (the "NAIC") held its 2010 Fall National Meeting (the "Fall Meeting") from October 16 to 21, 2010, in Orlando, Florida. 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) the NAIC's solvency modernization initiative; (2) the modernization of reinsurance regulation; (3) the group-wide supervision of insurance holding company systems; (4) revisions to the NAIC Insurance Holding Company System Regulatory Act and the Insurance Holding Company System Model Regulation; (5) the International Association of Insurance Supervisors' common framework for the supervision of internationally active insurance groups; (6) the corporate governance of insurers; (7) the disclosure of executive compensation information; (8) the valuation of commercial mortgage-backed securities; (9) risk-based capital calculations for life insurers; (10) principle-based reserving and capital standards for life insurers; (11) the calculation of medical loss ratios; (12) retained asset accounts; (13) stranger-originated annuity transactions; (14) annuity disclosure regulations; (15) perspectives on national catastrophe insurance programs and (16) climate change.

THE NAIC'S SOLVENCY MODERNIZATION INITIATIVE

At the Fall Meeting, the NAIC continued to make progress on its solvency modernization initiative. First announced in June of 2008, the solvency modernization initiative is, in the NAIC's words, "a critical self-examination to update the United States' insurance solvency regulation framework and includes a review of international developments regarding insurance supervision, banking supervision, and international accounting standards and their potential use in U.S. insurance regulation." The solvency modernization initiative is further described, at a high level, in a "road map" adopted at the Summer National Meeting of the NAIC (the "Summer Meeting").[1] The road map is a working document, subject to ongoing periodic revision by the NAIC, that sets out the policy direction and priorities for the solvency modernization initiative and seeks to clarify the role and scope of activities through

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[1] *A current version of the full* Roadmap*, which includes several proposed timelines for committee action, is available on the NAIC's website at http://www.naic.org/documents/committees_ex_isftf_summer_ntlmtg_meeting_smi_roadmap.pdf.*

year-end 2012. The road map focuses on five areas: capital requirements, governance and risk management, group supervision, statutory accounting and financial reporting, and reinsurance.

Among other things, the solvency modernization initiative has become a forum for organizing the response of the NAIC and its state insurance regulator-members to the International Monetary Fund's Financial Sector Assessment Program (FSAP) Report, published in May 2010, relating to the U.S. system of insurance regulation (the "FSAP Report"). The FSAP Report evaluated U.S. insurance regulation to assess observance by the U.S. of a set of core insurance regulatory principles articulated by the International Association of Insurance Supervisors (the "IAIS"). The U.S. received a rating of "observed" or "largely observed" for 25 of the 28 core principles. For the remaining principles, the U.S. received a rating of "partly observed." The areas of deficiency noted by the International Monetary Fund in these areas included, among others, the absence of "group-wide" regulatory supervision that transcends separate legal entities in large insurance organizations, the difficulty of achieving regulatory uniformity in a state-based system, the need for institutional reform to enhance the independence of state insurance departments from undue political influence, the paucity of specific legal requirements relating to the corporate governance of insurers, and the need for additional regulatory openness and transparency.

Because of its comprehensive scope, the solvency modernization initiative encompasses the efforts of a variety of tasks forces and working groups within the NAIC, including, among others, the task forces and working groups charged with the development of new principle-based requirements for life insurance reserves and capital, the task force charged with review of proposals to modernize the U.S. system of reinsurance regulation, the "group solvency issues" working group that has focused much of its efforts over the past year on the development of revised versions of the NAIC's Model Insurance Holding Company System Regulatory Act and Insurance Holding Company System Model Regulation, and a corporate governance working group charged with consideration of a potential model law that would set out corporate governance requirements uniquely applicable to insurers.

The Solvency Modernization Initiative is supervised within the NAIC by an executive level task force comprised of twenty state insurance regulators (the "SMI Executive Task Force"). The SMI Task Force met during the Fall Meeting to discuss the status of the initiative, to receive updates from its various subsidiary working groups and task forces, and to adopt charges for 2011 that are consistent with the road map. Specific activities of various solvency modernization initiative working groups and task forces at the Fall Meeting are discussed in detail below.

THE MODERNIZATION OF REINSURANCE REGULATION

For several years, the NAIC's Reinsurance (E) Task Force (the "Reinsurance Task Force") has been working diligently to modernize the existing U.S. system of reinsurance regulation. After a long period of deliberation, the efforts of the Reinsurance Task Force culminated in the adoption, in 2008, of a detailed "reinsurance regulatory modernization framework" (the "Modernization Proposal"). In the form adopted, the Modernization Proposal called for two fundamental changes to existing law: (1) the introduction of a system of mandatory regulatory deference, by U.S. states, to the credit for reinsurance requirements imposed in connection with a particular reinsurance arrangement by a reinsurer's "home state supervisor" (in the case of a cession to a U.S. reinsurer) or a single U.S. "port of entry supervisor" (in the case of a cession to a non-U.S. reinsurer) and (2) the introduction of a nationally uniform risk-based collateralization regime under which a reinsurer's statutory obligation to collateralize its reinsurance liabilities in all U.S. states would depend, among other things, upon measures of its financial strength. The risk-based collateralization regime would reduce, and in some cases eliminate, the amount of collateral that a highly rated reinsurer would be required to post in favor of its ceding insurers (though ceding insurers would remain free to negotiate with reinsurers for increased collateral).[2]

In the form adopted, the Modernization Proposal would have required federal enabling legislation. Among other things, because some fifteen U.S. states currently apply their credit for reinsurance laws on an extraterritorial basis to licensed insurers domiciled in other states, the implementation of the Modernization Proposal on a national basis would necessitate federal preemption of extraterritorial state credit for reinsurance rules. Consequently, in 2009, the Reinsurance Task Force developed and adopted the proposed Reinsurance Regulatory Modernization Act of 2009 (the "Modernization Act") for submission to the U.S. Congress. However, the NAIC was not able to obtain congressional sponsorship for the Modernization Act. As a result, the Modernization Act has not been enacted into law, at least not in the form initially proposed. Instead, the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act"), enacted on July 21, 2010, includes a provision that supersedes the Modernization Proposal's detailed mechanism of designating "home state supervisors" and "port of entry supervisors" to ensure regulatory deference to a single state for reinsurance credit purposes. Specifically, under Section 531(a) of the Dodd-Frank Act, beginning July 21, 2011, a U.S. ceding insurer need not satisfy the credit for

[2] *For additional detail regarding the Modernization Proposal, see our Client Update for the NAIC 2008 Fall National Meeting, available at www.debevoise.com.*

reinsurance rules of any state beyond its domicile if (1) the ceding insurer's domicile is accredited by the NAIC, or has financial solvency requirements substantially similar to the requirements necessary for NAIC accreditation, and (2) the ceding insurer's domicile recognizes credit for its ceded risk.[3] All of the 50 U.S. states are currently accredited by the NAIC.

Because the Dodd-Frank Act effectively nullifies the extraterritorial application of state credit for reinsurance rules, it opens the way for any particular state to introduce credit for reinsurance reforms that, once enacted, will apply to that state's domestic ceding insurers on a national basis. In 2007, for example, Florida enacted legislation, and promulgated companion regulations, that implement a statutory risk-based collateralization regime derived from the Modernization Proposal. A similar amendment to New York's Regulation 20 is currently pending. As a result of the Dodd-Frank Act, beginning July 21, 2011, these reforms will apply nationally to the domestic ceding insurers of these states.

In order to address the consequences of the Dodd-Frank Act, the NAIC is taking two steps. First, at the Fall Meeting, the Reinsurance Task Force adopted a set of recommendations to the NAIC's Financial Regulations and Accreditation (F) Committee (the "F Committee") outlining key elements of the Modernization Proposal that should be considered by the F Committee in determining whether any particular state credit for reinsurance reform is acceptable under NAIC accreditation standards. Second, at the Fall Meeting, the Reinsurance Task Force noted that it would begin considering amendments to the NAIC's Credit for Reinsurance Model Law and Credit for Reinsurance Model Regulation in order to make the models consistent with key elements of the Modernization Proposal.

The Reinsurance Task Force's NAIC accreditation recommendations are of particular importance because the NAIC's accreditation of a state, or the existence in a state of financial solvency requirements "substantially similar" to NAIC accreditation standards, is a condition to deference to a ceding insurer's domestic state credit for reinsurance rules under the Dodd-Frank Act. The NAIC accreditation process, generally, is a means by which state insurance regulators, acting collectively through the NAIC, monitor the regulatory effectiveness of state insurance departments as well as the adequacy of state insurance laws

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[3] *For additional detail, see our article, "Dodd-Frank Act – A Brave New World for U.S. Reinsurance Credit Rules?" in the August 2010 issue of the Debevoise & Plimpton Financial Institutions Report, available at www.debevoise.com.*

and regulations.[4] In light of the credit for reinsurance provisions of the Dodd-Frank Act, state insurance regulators are understandably keen to make clear exactly what types of credit for reinsurance reform will be acceptable to the F Committee in order for a state to remain NAIC accredited.

The recommendations adopted at the Fall Meeting identify the following elements that, in the words of the Reinsurance Task Force, "should be required to be evident in a state's laws and/or regulations … for those states choosing to reduce collateral for nonadmitted reinsurers" (namely, adding risk-based collateral to a state's reinsurance credit rules is optional and not a condition to remaining NAIC-accredited):

- new, risk-based collateralization requirements should apply only to reinsurance contracts entered into or renewed on or after the effective date of the implementing statute or regulation;
- affiliated reinsurance transactions may receive the same opportunity for reduced collateral requirements as all other reinsurance transactions;
- eligible assuming insurers (as determined by the state insurance regulator) must maintain capital and surplus of no less than $250 million;
- the maximum amount of collateral reduction must be consistent, at a minimum, with a scale, set out in the Modernization Proposal, that is calibrated to the assuming insurer's financial strength ratings by at least two approved rating agencies (notably, the Reinsurance Task Force has not indicated that it will revisit the use of a rating scale in light of ongoing consideration elsewhere within the NAIC and among other financial regulators of the need to reduce reliance on rating agencies in the regulation of financial solvency);
- an eligible assuming insurer must submit to the state insurance regulator an executed form stipulating that it submits to the jurisdiction of U.S. courts, appoints an agent for service of process in the U.S., and agrees to post 100% collateral for its U.S. liabilities if it resists enforcement of a final U.S. judgment; and

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[4] *An official description of the NAIC's state accreditation program can be found on the NAIC's website at http://www.naic.org/documents/committees_f_FRSA_pamphlet.pdf.*

- an eligible assuming insurer must periodically file with the state insurance regulator copies of (1) audited financial statements, regulatory filings and actuarial opinions filed with its domestic supervisor and (2) a report in the form of the applicable NAIC Annual Filing Blank, either Schedule F or Schedule S or, if acceptable to the state insurance regulator in his or her discretion, a report in a substantially similar form (Schedules F and S require detailed financial disclosure regarding an insurer's reinsurance transactions and reinsurance counterparties, including disclosure of reinsurance recoverables past due or in dispute).

In addition, the recommendations specify that as a condition to NAIC accreditation, state insurance regulators should evaluate the reinsurance supervisory systems of foreign jurisdictions or rely upon a list of approved jurisdictions maintained by the NAIC for non-U.S. assuming insurers, and should publish a listing of approved reinsurers and approved non-U.S. jurisdictions on a periodic basis.

In terms of next steps, the Reinsurance Task Force now plans to tackle revisions to the text of the NAIC's Credit for Reinsurance Model Law and Credit for Reinsurance Model Regulation to implement the risk-based collateral rules included in the Modernization Act. Members of the task force indicated that they would likely seek to schedule an interim in-person meeting among regulators in order to discuss these revisions.

GROUP-WIDE SUPERVISION OF INSURANCE HOLDING COMPANY SYSTEMS

At the Fall Meeting, the Group Solvency Issues (EX) Working Group (the "GSI Working Group") continued a discussion, ongoing now for several months, of possible means by which state insurance regulators could monitor the combined capital adequacy of all entities within an insurance holding company system. In advance of the Fall Meeting, the working group circulated a request for comment from interested parties on this topic. Among the options outlined in the request for comment are (1) the possibility of adjusting existing insurance company risk-based capital calculations to account for group-wide risks (for example, the risk of financial "contagion" from an insurer's affiliate), (2) the implementation of a group risk-based capital calculation and consolidated statutory financial statement at the level of the ultimate parent company in an insurance holding company system and (3) the possibility of requiring insurance holding company systems to conduct, and file with state insurance regulators, an "Own Risk Solvency Assessment" ("ORSA") at the group level. The ORSA is a concept borrowed from the Solvency II regime in the European Union. Essentially, it would consist of internal modeling and stress testing, designed and conducted in the first instance by the insurance group in accordance with prescribed regulatory criteria,

in order to assess the adequacy of capital levels in light of the insurance group's unique business mix and strategy.

During the Fall Meeting, state insurance regulators expressed some frustration with the insurance industry's response to the request for comment. As a general rule, insurers are hesitant to endorse new concepts of group regulatory capital that could create substantial additional administrative burdens and expenses for the industry. Insurers are also keen to ensure the confidentiality of information shared with regulators in order to assess group capital. An ORSA, in particular, would likely contain a wealth of competitively sensitive forward-looking information. Nonetheless, at the Fall Meeting, state insurance regulators communicated firmly their belief that new methods of assessing group capital levels are needed, especially in light of the findings in the International Monetary Fund's recent FSAP report that criticize the lack of group-level regulatory oversight in the U.S.

In the course of its deliberations, the GSI Working Group agreed to focus the NAIC's efforts on the development of a requirement for an ORSA. Accordingly, the working group expects to ask NAIC staff to develop an outline of a proposed ORSA requirement for discussion among state insurance regulators and interested parties. Similarly, in a separate session, the International Solvency (EX) Working Group discussed an NAIC consultation paper regarding a potential ORSA requirement. The SMI Task Force has charged the International Solvency (EX) Working Group in 2011 to consider developing new regulatory requirements, similar to or based on the ORSA, in order to assess and monitor the sufficiency of insurance company risk management processes.

While the NAIC appears intent on pursuing the adoption of an ORSA requirement, the consensus among the members of the GSI Working Group at the Fall Meeting was that it would not make sense, at this point, to pursue development of a group-level risk-based capital calculation. Among other things, in reaching this determination, state insurance regulators cited the difficulty of devising meaningful calculation methodologies and results for non-insurers.

REVISIONS TO THE MODEL INSURANCE HOLDING COMPANY ACT AND REGULATION

In connection with its solvency modernization initiative, the NAIC has been considering significant amendments to its model Insurance Holding Company System Regulatory Act (the "Model Act") and its Insurance Holding Company System Model Regulation (the "Model Regulation"). A brief summary of these amendments can be found in our Client Update regarding the Summer Meeting, available at www.debevoise.com. Although it was widely expected that these amendments would be adopted by the NAIC at the Fall Meeting,

Director Frohman of Nebraska (the Chair of the GSI Working Group) reported that the NAIC is continuing to review open issues relating to the amendments, in particular the concerns of interested parties regarding the confidentiality of information to be submitted to the NAIC pursuant to laws based on the revised models. Director Frohman stated that the NAIC continues to work toward adoption of the amendments before the end of 2010.

In the meantime, the GSI Working Group has exposed for comment a set of "holding company and supervisory college best practices." According to the GSI Working Group, these best practices are intended to provide useful guidance to state insurance regulators for the oversight of insurance holding company systems, and will be incorporated into existing NAIC handbooks and other publications used by insurance department analysts and financial examiners. The best practices cover topics such as cross-border coordination among regulators, information sharing with federal regulatory agencies, and issues for consideration in the review of company filings for the approval of mergers and acquisitions and inter-affiliate transactions. The holding company best practices also include guidelines applicable to investment managers or funds that acquire 10% or more of the voting securities of an insurer or an insurance group but who seek regulatory approval of an exemption from having to file a "Form A" application to acquire control, including guidelines to the effect that (1) the regulator should inquire about the ability of the investor to obtain a board seat as well as becoming a non-voting observer on the board, and (2) a regulatory approval of a exemption should include a requirement that the state receive an annual attestation from the investor that there are "no changes in investing philosophy." Comments on the best practices are due by the close of business on December 2, 2010.[5]

In addition, the GSI Working Group has exposed for comment a proposal setting out the elements of the amendments to the Model Act and Model Regulation that would be added to the standards used by the F Committee to determine whether a particular state insurance regulator should continue its accreditation status with the NAIC. Comments on this document are due by the close of business on December 17, 2010.[6]

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[5] *A draft of the best practices document is available on the NAIC's website at http://www.naic.org/documents/committees_ex_isftf_group_solvency_101019_hc_and_sc_best_practices_draft.pdf.*

[6] *A draft of the accreditation proposal is available on the NAIC's website at http://www.naic.org/documents/committees_ex_isftf_group_solvency_101019_hc_significant_elements.pdf.*

THE COMMON FRAMEWORK FOR THE SUPERVISION OF INTERNATIONALLY ACTIVE INSURANCE GROUPS

At the Fall Meeting, the SMI Task Force also discussed recent efforts by the IAIS to promote cross-border regulatory cooperation in the supervision of internationally active insurers.

The efforts of the IAIS are embodied in a proposed "Common Framework for the Supervision of Internationally Active Insurance Groups" ("ComFrame"). According to the IAIS, ComFrame is intended, among other things, to "establish a comprehensive framework for supervisors to address group-wide activities and risks and also set grounds for better supervisory cooperation in order to allow for a more integrated and international approach" by insurance regulators, and to "foster global convergence" of insurance regulation. NAIC Staff attended the annual conference of the IAIS in Dubai from October 27 to 29 to participate in a discussion among various international insurance regulators of ComFrame. In their discussion at the Fall Meeting, the SMI Executive Task Force endorsed a proposal, to be presented by NAIC staff at the IAIS annual conference, for the establishment of a standing IAIS committee of lead regulators of internationally active insurers. The proposed committee would meet regularly, in closed session, to share and discuss information and trends relating to relevant internationally active insurers.

CORPORATE GOVERNANCE OF INSURERS

At the Fall Meeting, the Corporate Governance (EX) Working Group discussed, among other things, a summary comparison prepared by NAIC staff of corporate governance and risk management standards imposed by international insurance regulators in Australia, Canada, Switzerland and the United Kingdom. The summary comparison covers "core principles" articulated by the IAIS relating to corporate governance and risk management. The comparison pays particular attention to the IAIS core principles that formed the basis of International Monetary Fund recommendations to U.S. regulators in its recent FSAP Report. Among other things, the NAIC staff report highlights International Monetary Fund recommendations to consider the following changes to the U.S. insurance regulatory regime:

- establishing specific suitability criteria for directors and other key persons;
- requiring companies to notify state insurance regulators of the ongoing suitability of directors and other key persons;
- publishing additional guidance for insurers relating to corporate governance and internal controls;

- explicitly requiring that insurers maintain an internal audit function;
- enacting legislation authorizing state insurance regulators to levy personal fines against directors and senior managers and to bar them from employment with insurers in the future;
- requiring insurers to maintain comprehensive risk management systems capable of identifying, measuring, assessing, reporting and controlling risks; and
- requiring insurers to have in place strategic underwriting and pricing policies approved and reviewed regularly by the board of directors.

In terms of next steps, the working group plans to ask NAIC staff to use the IAIS core principles, FSAP recommendations and its international summary comparison to create an outline of key corporate governance principles for discussion among state insurance regulators and interested parties. By this coming spring, the working group aims to reach agreement on these principles, after which it will decide whether to proceed with the development of a specific model law relating to corporate governance. Several of the working group members urged insurance industry representatives to keep an open mind when reviewing the working group's proposed corporate governance principles, indicating that state insurance regulators would ultimately find it difficult to accept an industry position that advocates no reform at all of existing corporate governance standards.

DISCLOSURE OF EXECUTIVE COMPENSATION INFORMATION

At the Fall Meeting, the Corporate Governance (E) Working Group received a referral from the NAIC/AICPA (E) Working Group to consider the adoption of new insurance regulations based on amendments by the U.S. Securities and Exchange Commission (the "SEC"), which became effective earlier this year, to the proxy disclosure rules applicable to public companies. The SEC's amendments are contained in SEC Release No. 33-9089 and require, among other things, 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;
- 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.

Prior to making its referral, the NAIC/AICPA (E) Working Group developed and circulated, for discussion purposes, a proposal to require insurers to make disclosures similar to those required by the SEC in a comprehensive supplement to the statutory annual statement, titled "Compensation Policies and Risk Practices Discussion," on April 1 of each year beginning in 2011, as well as additional information to be included in the supplemental compensation exhibit to the annual statutory financial statement. Interested parties, in turn, prepared a counterproposal that would require substantially less periodic disclosure, and would incorporate concepts derived from the new SEC rules into the NAIC handbook used by financial examiners conducting periodic regulatory exams of insurers.

Although there was no substantive discussion of the foregoing proposals at the meeting of the Corporate Governance (E) Working Group, the working group expects to incorporate the referral into its work on corporate governance issues over the coming months.

VALUATION OF COMMERCIAL MORTGAGE-BACKED SECURITIES

As we reported in our Client Update regarding the NAIC 2010 Spring National Meeting, available at www.debevoise.com, beginning year-end 2009, the NAIC decided to cease using credit ratings assigned by nationally recognized statistical rating organizations for its determination of risk-based capital calculations applicable to non-agency residential mortgage-backed securities ("RMBS"). Instead, the NAIC decided to use an alternative financial model developed by Pacific Investment Management Company ("PIMCO") on the NAIC's behalf.

At the Fall Meeting, the NAIC's Valuation of Securities (E) Task Force (the "VOS Task Force") received a report on the status of the RMBS project from NAIC staff. The report lauded the success of the project and highlighted the significant decrease in risk-based capital charges resulting from the "intrinsic value" approach to RMBS of the PIMCO model, and confirmed that the VOS Task Force had agreed to implement a similar approach for valuation of commercial mortgage-backed securities ("CMBS"). Given some of the distinctive characteristics of CMBS – for example, unique loan documentation for each mortgage, the heterogeneous nature of the collateral, and the significant impact that the

default of a single mortgage can have on a CMBS tranche – the NAIC felt that a separate RFP process for selecting a CMBS modeling vendor was warranted. BlackRock Solutions was ultimately selected to model CMBS; PIMCO has been retained again for RMBS modeling for 2010. NAIC staff and VOS Task Force members are currently finalizing the macroeconomic assumptions and scenarios to be built into the models for both asset classes. Final results of the modeling process are expected to be made available to insurers in late December.

RISK-BASED CAPITAL CALCULATIONS FOR LIFE INSURERS

During the Fall Meeting, the Life Risk-Based Capital (E) Working Group (the "RBC Working Group") convened to discuss, among other things, ongoing work relating to the risk-based capital treatment of commercial mortgage loans, a proposal from the American Council of Life Insurers (the "ACLI") to change risk-based capital requirements for derivatives used as hedges and the risk-based capital treatment of non-U.S. insurer subsidiaries of mutual insurers.

With regard to commercial mortgages, the RBC Working Group is working to devise a long-term solution to replace the existing mortgage experience adjustment factor. At the Fall Meeting, the RBC Working Group received an update from the ACLI regarding this project. Work continues apace, and a conference call will be scheduled in the near future for the working group to finalize relevant modeling assumptions and methodologies. Working group members remarked that the long-term solution is unlikely to be ready for implementation for year-end 2011 statutory financial statements and is more likely to be ready for implementation beginning with year-end 2012 statutory financial statements.

The RBC Working Group also discussed the ACLI's proposal for changes to the risk-based capital requirements for derivatives, which is described in greater detail in our Client Update regarding the Summer Meeting, available at www.debevoise.com. Since the Summer Meeting, the New York Insurance Department has raised objections to the ACLI's proposal. The point of contention relates to the "accounting mismatch" that results when statutory accounting principles require a life insurer to carry a hedged bond on its balance sheet at amortized cost while simultaneously using fair value accounting to track the value of the associated credit default swap that hedges the bond. If the credit quality and fair value of the hedged bond declines, then the fair value of the associated credit default swap increases, but the value of the hedged bond does not decrease absent an "other than temporary impairment." The result, potentially, is a distortion of statutory surplus. The New York Insurance Department has proposed an adjustment to the calculation of total adjusted capital in order to address this potential distortion. The ACLI, however, would prefer to proceed to finalize its proposal in the form proposed and refer the issue to the NAIC's

Statutory Accounting Principles Working Group for separate consideration. The RBC Working Group voted to expose the ACLI proposal, including the proposed New York Insurance Department adjustment, for a comment period of thirty days.

Finally, the RBC Working Group adopted a proposal, first exposed for comment during the Summer Meeting, to change the risk-based capital instructions applicable to life insurers in order to correct an anomalous impact of foreign life insurer subsidiaries on a parent mutual insurer's risk-based capital ratio. Under the current regime, an increase in the statutory carrying value of a foreign life insurance subsidiary may have the effect of decreasing the parent mutual insurer's risk-based capital ratio. Because most stock life insurers employ an ownership structure in which foreign life insurer subsidiaries are owned by non-insurance holding companies, this anomaly would typically affect only mutual life insurers. After its adoption by the RBC Working Group, the proposal was adopted both by the NAIC's Capital Adequacy (E) Task Force and the E Committee, and is slated to become effective beginning with statutory financial statements for the year ending 2011.

PRINCIPLE-BASED RESERVING AND CAPITAL STANDARDS FOR LIFE INSURERS

At the Fall Meeting, the Life and Health Actuarial Task Force ("LHATF") continued its work on various topics relating to the emerging regime of principle-based reserving and capital standards for life insurers. Although LHATF has made meaningful progress in the development of the detailed regulatory mechanisms required to implement the new principle-based approach to life insurance and annuity reserves, the achievement of consensus within the working group remains difficult, and considerable work remains before principle-based reserves can take effect.

At this point, a significant focus for LHATF is an impact study to be completed over the coming months. The impact study will analyze the likely effect of proposed principle-based methodologies on the life insurance industry in the United States, and will compare them to current reserving methodologies. The NAIC has selected Towers Watson to act as a consultant in connection with the impact study and is in the process of surveying life insurers regarding potential participation in the study. Planning and training sessions to prepare for the impact study are scheduled to take place in the next few weeks. Work on the impact study is currently expected to be completed by March 31, 2011.

During the Fall Meeting, LHATF also discussed, among other things, the development of a principle-based reserving "feedback loop" in order to evaluate, on an ongoing basis, the efficacy of principle-based reserves after the new regime has come into force. LHATF

decided to form a subgroup, to be chaired by South Carolina, to draft a white paper on this issue.

THE CALCULATION OF MEDICAL LOSS RATIOS

As has been widely reported in the media, at the Fall Meeting, the NAIC's Joint Executive (EX) Committee/Plenary sessions voted to adopt a model regulation containing the definitions and methodologies for calculating medical loss ratios, as required by the comprehensive federal healthcare reform enacted earlier this year pursuant to the U.S. Patient Protection and Affordable Care Act of 2010 (the "PPACA"). The final model was the result of a collaborative effort on the part of a number of NAIC subgroups and committees, and will be delivered to the Department of Health and Human Services for certification by the U.S. Secretary of Health and Human Services ahead of the PPACA-mandated deadline of December 31, 2010.

In general terms, the medical loss ratio refers to the ratio of the amount an insurer spends in reimbursement for medical services to the amount of premiums collected. The PPACA requires a minimum ratio of 80 percent for plans offered in the individual and small group markets, or 85 percent for plans offered in the large group market. If an insurer's medical loss ratio falls below the applicable threshold, excess premiums must be reimbursed to policyholders. Prior to the final vote, there was intense debate among the state insurance regulators with respect to the definition of various components of an insurer's medical loss ratio. Discussions reflected the comments of insurers received prior to the meeting that sought broader definitions of what constitutes medical expenses (for example, inclusion of fraud control efforts and billing costs) while stripping out elements of the definition of premium revenue (for example, commissions forwarded to third parties, such as producers), as well as comments received from consumer groups with opposing objectives.

Three contentious last-minute amendments were discussed but ultimately failed to pass. The first would have allowed insurers to deduct producer commissions from premiums. The second proposed amendment sought to permit insurers to average their medical spending based on their nationwide aggregate costs, rather than calculate it on a state-by-state basis. The third proposal would have loosened a complex "credibility adjustment" formula to give greater leeway to insurers, particularly smaller ones, to reach their minimum loss ratio targets without spending 80 percent of premiums on medical care. (The purpose of the credibility adjustment is to allow addbacks to the medical costs numerator in recognition of the volatility inherent in smaller and newer blocks of business.)

RETAINED ASSET ACCOUNTS

Since its Summer Meeting, the NAIC has been engaged in extensive deliberations regarding issues relating to retained asset accounts ("RAAs") used by major U.S. life insurers. The NAIC embarked on a review of RAAs in response to press coverage of RAAs and the announcement of related investigations by the New York State Attorney General and other government offices during the summer months. During the Fall Meeting, the NAIC focused on two proposals regarding RAAs, each described in more detail below: (1) the preparation of an updated model insurer bulletin, to be distributed by state insurance regulators to insurers licensed in their respective states and (2) the adoption of additional financial disclosure that life insurers will be required to make in periodic statutory financial statements filed with state insurance regulators.

RAA Survey and Model Bulletin. RAAs hold the proceeds of life insurance policies after the death of the insured. The beneficiary is issued drafts which may be used to draw upon all or part of the RAA at any time and interest accrues on the amount held. The assets that support the RAA are typically held in the insurer's general account, and the insurer bears the risk of investment losses and retains any profits from excess investment returns. The funds in the accounts are not guaranteed by the FDIC but generally are covered by state life and health insurance guaranty associations.

In advance of the Fall Meeting, the NAIC's Retained Asset Account Working Group (the "RAA Working Group") distributed a survey to various U.S. life insurers requesting information regarding the use of RAAs, together with representative samples of disclosures provided to life insurance beneficiaries, relevant policy language and claim forms. By mid-October, thirty companies had responded to the NAIC survey, with thirteen reporting that they do not use RAAs.

After collecting the survey results, a subgroup of the RAA Working Group examined the disclosure and claim forms submitted by thirteen of the survey respondents, and compared those forms to a set of "best practices" set out in a model bulletin on RAAs adopted by the NAIC in 1994. The NAIC has not disclosed the identities of the thirteen companies whose forms were subjected to this review. During the Fall Meeting, the RAA Working Group discussed the results of this review, which were summarized in a set of written "preliminary findings" delivered to the RAA Working Group by insurance regulators from Connecticut, Iowa, New Hampshire and Ohio. The preliminary findings included a list of life insurer disclosures that the regulators believe to be "appropriate" and a contrasting list setting out "areas of possible improvement." The preliminary findings also highlight as a "key policy discussion point" the potential establishment of a system for filing of the supplementary

contracts that govern RAAs with state insurance regulators (similar to the current regime for the filing of policy forms).

The discussion at the Fall Meeting focused on the "areas of possible improvement" outlined in the regulators' preliminary findings, as follows:

- companies generally portray RAAs as "checkbooks" rather than draft accounts, leading to possible confusion for consumers;
- companies do not always indicate where the proceeds are kept (*i.e.,* transferred to a bank or kept in the company's general account);
- while companies indicate that interest will be earned, companies generally do not provide the interest rate to be earned in the initial disclosure form;
- companies do not always clarify whether the funds are FDIC-insured;
- companies do not refer to the protection of state guaranty association coverage, when applicable;
- the disclosure forms vary widely in length from insurer to insurer; and
- additional disclosures may be needed regarding the proceeds exceeding FDIC and state guaranty association coverage.

In order to rectify these perceived shortcomings, the RAA Working Group directed a subgroup to prepare a revised model insurer bulletin that would require insurers to make disclosures to consumers on these topics upon receipt of a death benefit claim, and that would require the filing of claim forms and disclosure documents with state insurance regulators in advance of use.

Notably, at this point, the working group appears committed to pursuing reforms that would mandate additional disclosure, but that would not necessitate structural changes to RAAs currently in use by life insurers. For example, the RAA Working Group does not appear to favor a prohibition, advocated by some state legislators and consumer advocates, on the use of an RAA if the policyholder or beneficiary has not affirmatively "opted in." In addition, the RAA Working Group seems satisfied to seek reform through a model insurer bulletin rather than a new model law. The NAIC's approach on this point contrasts with the approach of the National Conference of Insurance Legislators, which has prepared and will likely soon adopt a model law, titled the "Beneficiaries' Bill of Rights." If enacted in a state,

NCOIL's model law would mandate a variety of additional disclosures by life insurers in connection with the use of RAAs, including the additional disclosures under consideration by the NAIC, and would deem any failure to make a required disclosure to be a violation of the relevant state's unfair trade practices statute.

Required Statutory Financial Statement Disclosure. At the Fall Meeting, the NAIC's Financial Condition (E) Committee (the "E Committee") adopted a set of new financial disclosures regarding RAAs that U.S. life insurers must include in their unaudited statutory financial statements, beginning with the 2010 annual statement. The required disclosures will include "a narrative description of how the accounts are structured and reported within the reporting entity's financial statements … [including] all of the different interest rates paid to retained asset account holders during the reporting year and the number of times changes in rates were made during the reporting year." In addition, life insurers will be required to disclose (1) fees charged that are "directly or indirectly associated with" the RAAs, (2) whether RAAs are the "default method" for satisfying life insurance claims and (3) data that identifies the aging of RAAs, the number and amount of RAAs turned over to state unclaimed property funds, and various RAA-related data segregated between individual and group life contracts.

STRANGER-ORIGINATED ANNUITY TRANSACTIONS

On September 22, 2010, the NAIC's Life Insurance and Annuities (A) Committee (the "A Committee") released for comment a draft model insurer bulletin to address regulatory concerns about the occurrence of transactions in which agents or investors offer terminally ill individuals a nominal fee to act as the measuring life on an annuity, known as stranger-originated annuity ("STOA") transactions. In one type of STOA transaction discussed in press reports and at a public hearing sponsored earlier this year by the NAIC, an investor uses a variable annuity with a guaranteed minimum death benefit to make speculative short-term investments during the remaining life of the annuitant. If the investments perform well, the investor collects the profit upon the annuitant's death, and if the investments perform poorly, the investor collects the guaranteed minimum death benefit. The investor is the designated beneficiary and will receive a return that is linked to the annuitant's death despite having no familial or insurable interest in the terminally ill annuitant. The draft model bulletin recommends actions that insurers should take to detect and prevent STOA transactions.

At the Fall Meeting, the A Committee heard from a number of interested parties regarding various aspects of the draft model bulletin. At the conclusion of the discussion, the A Committee charged a new subgroup with preparation of a revised draft of the model bulletin for further review and consideration.

ANNUITY DISCLOSURE REGULATIONS

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 to consumers of annuity products. At the Fall Meeting, the A Committee exposed, for a thirty day comment period, changes to the Model Disclosure Regulation adopted by the Annuity Disclosure Working Group. The proposed changes are the result of extensive deliberations over many months by the Annuity Disclosure Working Group. As a consequence, the A Committee has asked that interested parties limit any further comments to matters that were not previously discussed and resolved before the Annuity Disclosure Working Group.

Among the significant proposed changes to the Model Disclosure Regulation are those listed below:

- The scope of the Model Disclosure Regulation has been broadened to include variable annuities and other registered products and, similar to the NAIC's Suitability in Annuity Transactions Model Regulation, contains a safe harbor for SEC- and FINRA-approved disclosure documents. Delivery of a buyer's guide for variable annuity sales will in any event be required.

- The disclosure requirements for indexed annuity products have been enhanced and clarified. For example, as revised, the Model Disclosure Regulation requires that an insurer provide a consumer with an explanation of how index-based interest is determined, a specification of the factors used in such determination and disclosure of the amount of lost interest that would result from withdrawal from or surrender of the contract.

- A new section titled "Standards for Annuity Illustrations" has been added to the Model Disclosure Regulation to govern the use by insurers of illustrations in the sale of annuity products. While use of illustrations in conjunction with the marketing of annuities is not mandatory, if illustrations are used, (1) they must be prepared by the insurer or a third party authorized by the insurer and subject to a system of control by the insurer over use of the illustrations and (2) there are explicit limitations on the use of assumptions, certain terms and descriptions of benefits and, in the case of an illustration of non-guaranteed values, a requirement that only current conditions and not assumed future conditions be used. In addition, the revised Model Disclosure Regulation includes several additional

provisions that set out specific requirements applicable to indexed annuities and annuities with market value adjustments.

PERSPECTIVES ON NATIONAL CATASTROPHE INSURANCE PROGRAMS

At the Fall Meeting, members of the Catastrophe Insurance (C) Working Group (the "Catastrophe Working Group") heard presentations regarding federal government intervention in the market for catastrophe insurance. A representative of the Property Casualty Insurers Association of America (the "PCIAA") presented a summary of views of the PCIAA as set forth in the PCIAA's recently published Natural Catastrophe Guidebook (the "Guidebook"). The Guidebook describes difficulties faced by recent legislative efforts to implement comprehensive catastrophe insurance programs, whether in the guise of federal reinsurance funds, the provision of federal guarantees of state funds set up to provide post-loss financing or grants to states for programs aimed at preventing and mitigating natural catastrophe losses. The PCIAA representative observed that the current political climate makes enactment of comprehensive federal regulatory solutions particularly unlikely and suggested that broad federal involvement would not necessarily provide the most efficient resolution of challenges facing the market for catastrophe insurance. Rather, it may make sense to tailor federal legislative efforts to address specific issues such as assistance for lower-income individuals and mitigation initiatives.

Another perspective was provided by a representative of United Policyholders, a consumer advocacy group. This presentation focused on residual market mechanisms, which are underwriting associations or organizations created under special state legislation to provide coverage (most commonly workers' compensation, personal automobile liability and property insurance) for individuals and businesses rejected by voluntary market property/casualty insurers. Coverage may be multi-peril, but is often restricted to one type of risk such as windstorm or earthquake. The presentation highlighted some of the unique challenges faced by residual insurers, including: (1) the requirement that they accept all comers; (2) staffing and infrastructure limitations and (3) legislative restrictions on budgets and mandatory periodic sunsets and reauthorization requirements.

CLIMATE CHANGE

At the Fall Meeting, the Climate Change and Global Warming (EX) Task Force gave a brief update on the status of the Insurer Climate Risk Disclosure Survey (the "Climate Survey"). The Climate Survey was originally adopted at the NAIC 2009 Spring National Meeting and

then revised at the NAIC 2010 Spring National Meeting amid significant debate.[7] Only a few states – notably, California, Pennsylvania and New Jersey – have assembled responses to their versions of the Climate Survey. The Climate Survey was intended to be annual but the tepid reception that the Climate Survey has received in many states leaves it uncertain whether additional states will take the Climate Survey initiative forward.

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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[7] *For additional discussion of the Climate Survey, see our Client Update regarding the NAIC 2010 Spring Meeting, available at www.debevoise.com.*.