NAIC DECEMBER 2010 JOINT EXECUTIVE COMMITTEE / PLENARY MEETING

December 20, 2010

To Our Clients and Friends:

The National Association of Insurance Commissioners (the "NAIC") held a Joint Executive Committee / Plenary Meeting on December 16, 2010 ("Plenary Meeting"). This Client Update highlights some of the developments from the Plenary Meeting that are of particular interest to many of our insurance industry clients, including developments relating to: (1) amendments to the NAIC Model Insurance Holding Company System Regulatory Act and Model Regulation; (2) reinsurance collateral reduction and accreditation reform efforts; (3) the Nonadmitted Insurance Multi-State Agreement; and (4) retained asset accounts.

AMENDMENTS TO THE NAIC'S MODEL INSURANCE HOLDING COMPANY ACT AND REGULATION

As part of 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"). It had been expected that the NAIC would adopt amendments to the models at its Fall Meeting, but the matter was deferred so that the NAIC could take more time to review open issues relating to the amendments. In particular, interested parties had expressed concern regarding the confidentiality of information to be submitted to the NAIC pursuant to laws based on the revised models. Having considered these issues, the Financial Condition (E) Committee submitted the amended Model Act and the Model Regulation to the Plenary Meeting, which adopted both models with additional amendments.[1]

The versions of the Model Act and Model Regulation adopted at the Plenary Meeting augment the power of regulators to supervise insurance holding company systems, while also providing enhanced confidentiality protections for information the companies now must submit to regulators. The key features of the amended Model Act and Model Regulation now adopted by the NAIC include:

- the consideration of "enterprise risk" as an activity, circumstance, event or series of events involving one or more affiliates of an insurer that is likely to have a material

1 *A more detailed description of the amended Model Act and Model Regulation will be published separately.*

adverse affect on the financial condition of the insurer or the insurance holding company system, and a new requirement that the ultimate controlling person of an insurer file an annual enterprise risk report on a new Form F;

- several requirements concerning acquisitions and divestments of insurers, including:
  - a requirement that any controlling person of a domestic insurer seeking to divest its controlling interest file a confidential notice of the proposed divestiture with the domestic insurance regulator at least 30 days prior to the cessation of control;
  - a requirement that a person acquiring control of a domestic insurer file a pre-acquisition notification regarding market share with the regulator on Form E;
  - a requirement that any person acquiring a controlling interest in a domestic insurer (a) agree to provide an annual report of the ultimate controlling person of the insurance holding company system, identifying material risks within the system that could pose an enterprise risk to the insurer and (b) acknowledge that the person and all subsidiaries within its control in the insurance holding company system will provide any information requested by the domestic insurer's regulator to evaluate enterprise risk to the insurer;
  - the provision for consolidated public hearings if a proposed acquisition of control will require the approval of more than one insurance regulator; and
  - a new authority for an insurance regulator to disapprove dividends or distributions and to place an insurer under an order of supervision if any person appears to have violated filing and other requirements related to the acquisition of control of or merger with a domestic insurer;
- a requirement that an insurer file, at the request of its regulator, financial statements of or within an insurance holding company system, including all affiliates (which may be satisfied by providing the most recently filed parent corporation financial statements that have been filed with the Securities and Exchange Commission);
- additional required statements in a registration filing that the insurer's board of directors oversees corporate governance and internal controls and that senior management has approved, implemented and maintained such governance and controls;
- a more detailed timeframe for filing of a disclaimer of control;

- the inclusion of amendments or modifications of previously filed affiliate transactions, as well as reinsurance pooling agreements and tax allocation agreements, in the types of transactions requiring notice to and approval by a domestic insurer's insurance regulator;
- expansion of an insurance regulator's scope of authority to include the power to (1) order an insurer to produce for examination documents or information to which the insurer can obtain access to pursuant to contractual relationships and (2) compel production, including by issuing subpoenas, administering oaths and examining persons under oath to determine compliance;
- provisions for an insurance regulator to participate in a supervisory college with other regulators for supervision of a domestic insurer that is part of an insurance holding company system with international operations;
- changes to confidentiality standards, including additional permissive sharing by an insurance regulator with other regulators of filed information concerning an insurer or holding company system, subject to limitations intended to ensure that information shared with other regulators or with the NAIC will remain confidential and privileged and will not be subject to disclosure or subpoena, or subject to discovery or admissible in evidence in any private civil action; and
- additional details set forth in the Model Regulation for the filing of affiliate cost sharing and management services subject to prior notice via a Form D filing.

Topics of discussion that will remain under consideration in future deliberations include the accreditation standards that will accompany adoption of the Model Act and Model Regulation, as well as continuing attention to maintaining the confidentiality of additional holding company system information that will be required for disclosure under the new rules adopted pursuant to the NAIC models.

REINSURANCE COLLATERAL REDUCTION AND ACCREDITATION REFORM EFFORTS

The enactment of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act") will essentially invalidate the extraterritorial application of certain state credit for reinsurance rules, creating the opportunity for an individual state to enact credit for reinsurance laws that would apply to that state's domestic ceding insurers nationwide. Section 531(a) of the Dodd-Frank Act provides that, beginning July 21, 2011, a U.S. ceding insurer need not satisfy the credit for 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.[2] Since all of the 50 U.S. states are currently accredited by the NAIC, each state's credit for reinsurance laws will apply on a national basis to the state's domestic ceding insurers.

In reviewing individual state-based plans for reinsurance collateral reduction, the Financial Regulation Standards and Accreditation (F) Committee made an informal request to the Reinsurance (E) Task Force to consider which elements of the NAIC Reinsurance Framework are most relevant in evaluating state initiatives to determine whether such reforms meet the accreditation standards of the NAIC. These recommendations may ultimately be incorporated into the Credit for Reinsurance Model Law and Regulation, and are of particular importance because the NAIC's accreditation of a state, or a state's enactment of financial solvency requirements "substantially similar" to those required for NAIC accreditation, is a basis for deference to a ceding insurer's domestic state credit for reinsurance rules under the Dodd-Frank Act.

The Reinsurance Task Force and Financial Condition (E) Committee adopted a set of recommendations at the Fall Meeting that were presented at the Plenary Meeting for discussion.[3] The NAIC adopted the recommendations, which will provide its Financial Regulation Standards and Accreditation (F) Committee with criteria by which to evaluate whether a state's proposed changes to its "risk-based" collateral rules will maintain or improve an insurer's financial stability and thus determine whether the state may remain NAIC-accredited. Key features of the recommendations include:

- the maintenance by eligible assuming insurers of capital and surplus of no less than $250 million;
- a requirement that the maximum amount of collateral reduction be consistent, at a minimum, with a scale that is calibrated to the assuming insurer's financial strength ratings by at least two approved rating agencies;
- periodic required filings with an eligible assuming insurer's insurance regulator of copies of (1) audited financial statements, regulatory filings and actuarial opinions filed with its domestic supervisor; (2) a report in the form substantially similar to the applicable NAIC

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2 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.

3 For a description of the recommendations adopted at the Fall Meeting, see our Client Update for the 2010 Fall National Meeting, available at www.debevoise.com.

Annual Filing Blank, either Schedule F or Schedule S; (3) a report of recoverables in dispute more than 90 days past due; (4) the report of an independent auditor on the financial statements of the insurance enterprise; and (5) a certification from the domiciliary supervisor that the eligible assuming insurer is in good standing and a list of any regulatory actions against the insurer; and

- a provision that an eligible assuming insurer would not have to post collateral for catastrophe recoverables for a period of one year from the date of the first instance of a liability reserve entry by the ceding company as a result of a loss from a defined catastrophic occurrence as recognized by the eligible assuming insurer's insurance regulator.[4]

The material accompanying the recommendations suggests that these principles may, in the future, become relevant in developing amendments to the NAIC Credit for Reinsurance Model Law and Regulation, but no timeline for work on such amendments was discussed at the Plenary Meeting.

THE NONADMITTED INSURANCE MULTI-STATE AGREEMENT

Another aspect of reform mandated by the Dodd-Frank Act, implemented through the Nonadmitted and Reinsurance Reform Act of 2010 ("NRRA"), is the requirement that only an insured's "home state" may impose a premium tax on nonadmitted insurance, effective July 21, 2011. In response, the NAIC created the Surplus Lines Implementation Task Force ("SLI Task Force") to develop an interstate compact, as authorized by the NRRA, that would set forth procedures for allocating nonadmitted insurance premium taxes among the signatory states. The SLI Task Force developed the Nonadmitted Insurance Multi-State Agreement ("NIMA") as a result, and after incorporating various amendments submitted a draft for review at the Plenary Meeting, which in turn unanimously adopted NIMA.

Starting from the premise that each state should be able to preserve its ability to receive premium taxes related to surplus lines insurance based on the exposure to risk from nonadmitted insurance within its borders, NIMA will function as a short-term solution that will allow states to prevent the loss of premium tax revenue from surplus lines business to the surplus lines insurer's home state. Its major features include:

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4 *The full text of the reinsurance collateral reduction and accreditation recommendations can be found on the NAIC's website at http://www.naic.org/documents/committees_exec_plenary_101216_reinsurance_collateral_reduction.pdf.*

- establishment of a clearinghouse for collection and distribution of premium taxes and transaction data related to nonadmitted insurance of multi-state risks, with uniform reporting and filing of contracts between the individual participating state and the clearinghouse;
- provision for individual insureds and surplus lines licensees who independently procure insurance to use the clearinghouse for reporting and payment of nonadmitted insurance premium taxes for multi-state risks;
- preservation of a role for surplus lines stamping offices, permitting such a stamping office to impose stamping fees in addition to the premium tax, in accordance with the laws of the home state of the stamping office; and
- requiring states to adopt a blended premium tax rate including all applicable taxes and fees across jurisdictions, calculated pursuant to the terms of NIMA.

Regulators speaking at the Plenary Meeting praised NIMA for its flexible approach in allowing participating states to redistribute surplus lines premium taxes in light of the NRRA reforms.

RETAINED ASSET ACCOUNTS

At the conclusion of the NAIC Fall Meeting, the Retained Asset Account Working Group (the "RAA Working Group") was charged with preparing an updated model disclosure bulletin, to be distributed by state insurance regulators to insurers licensed in their respective states, that would establish rules for the timing and substance of disclosure by a life insurer that may use a retained asset account ("RAA") to settle life insurance benefits. Using the NAIC 1995 Model Bulletin as the base, the RAA Working Group adopted revisions to the Retained Asset Accounts Sample Bulletin (the "Bulletin"), which was adopted with minor amendments at the Plenary Meeting.

The Bulletin as adopted at the Plenary Meeting contains more detailed disclosure requirements mandating that an insurer that uses or may use an RAA to settle benefits must disclose to beneficiaries certain information about the RAA before any such account is selected or established. Substantive provisions of the newly adopted Bulletin also include requirements that insurers provide disclosures to beneficiaries of life insurance benefits by means of an RAA, *before* the RAA is selected (if optional) or established (if not optional), including:

- that payment of the full benefit amount is accomplished by delivery of the "draft book"/"check book";

- that a draft or check may be written to access the entire amount of the RAA at any time;
- whether other available settlement options are preserved until the entire balance is withdrawn or drops below the insurer's minimum balance requirements;
- that the RAA is either a checking or a draft account and an explanation of how the account works;
- information about the account services provided and contact information where the beneficiary may request and obtain more details;
- a description of any fees charged;
- the frequency of statements to be provided regarding the RAA;
- the minimum interest rate to be credited to the RAA and how the actual interest rate will be determined;
- that the interest earned on the RAA may be taxable;
- that funds held in the RAA are not guaranteed by the Federal Deposit Insurance Corporation (the "FDIC") but are guaranteed by individual state guaranty associations; and
- a description of the insurer's policy regarding RAAs that may become inactive.

Amendments approved at the Plenary Meeting sought to clarify that the scope of the Bulletin applies strictly to RAAs and included elimination of a reference to "cash surrender value" in order to clarify that the Bulletin applies only to beneficiaries and not to policyholders, and clarification of the definition of RAA to include only accounts with check or draft writing privileges. Opinions were also voiced at the Plenary Meeting that it is appropriate to require disclosure that funds are not FDIC-guaranteed but are guaranteed by state guaranty associations even though guaranty fund laws generally prohibit the advertising of guaranty fund coverage for the purpose of inducing an individual to purchase insurance which is covered by the guaranty fund. Such a prohibition is included in the NAIC Life and Health Insurance Guaranty Association Model Act. However, since these newly mandated disclosures will *not* take place in connection with the marketing or sale of insurance policies, but only in RAA-related disclosures to existing beneficiaries after the marketing and sale of insurance has already taken place, the Plenary concluded the disclosure of guaranty association coverage was appropriate to fully inform beneficiaries as to the risks and safeguards associated with holding settled benefits in an RAA.

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.

Eric R. Dinallo
+1 212 909 6344
erdinallo@debevoise.com

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

Thomas M. Kelly
+1 212 909 6907
tmkelly@debevoise.com

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

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

Christopher J. Ray
+1 212 909 6206
cjray@debevoise.com