DEBEVOISE & PLIMPTON LLP

CLIENT UPDATE D&P

NAIC 2011 SPRING NATIONAL MEETING

April 6, 2011

To Our Clients and Friends:

The National Association of Insurance Commissioners (the "NAIC") held its 2011 Spring National Meeting (the "Spring Meeting") from March 24 to 29, 2011, in Austin, Texas. 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) amendments to the Credit for Reinsurance Model Law and Regulation; (2) Dodd-Frank receivership implementation; (3) the common framework for the supervision of internationally active insurance groups; (4) supervisory colleges; (5) international solvency initiatives; (6) corporate governance of insurers; (7) stranger-originated annuity transactions; (8) annuity disclosure regulations; (9) principle-based reserving and capital standards for life insurers; (10) risk-based capital calculations for life insurers; (11) FDIC-guaranteed securities; (12) a new governmental securities rating framework; (13) working capital finance notes; and (14) the recent catastrophic events in Japan.

AMENDMENTS TO THE CREDIT FOR REINSURANCE MODEL LAW AND REGULATION

The Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act") includes in Title V the Nonadmitted and Reinsurance Reform Act (the "NRRA"), which will 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.[1] 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 its domestic ceding insurers. The Reinsurance (E) Task Force has been developing amended versions of the Credit for Reinsurance Model Law

1 *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/financialinstitutionsreport*

and Regulation. The amended models put forward for comment at the Spring Meeting contain several important changes from the existing models, including the elimination of regulations on credit allowed a foreign ceding insurer and the introduction of a risk-based collateral regime for certified foreign reinsurers consisting of the (1) provision of state insurance commissioners with new powers to certify a foreign reinsurer to conduct business in their respective states and determine qualifying jurisdictions in which a foreign reinsurer must be domiciled in order to be eligible for certification; (2) implementation of a sliding scale of collateral posting requirements for a certified foreign reinsurer; and (3) imposition of certain additional mandatory contractual provisions for reinsurance transactions with a certified foreign reinsurer. The amended models were the subject of vigorous comment by industry participants. Among the key areas of concern raised by participants relating to the risk-based collateral provisions were:

- whether a certified foreign reinsurer downgraded to an A- rating should be required to post collateral of 20%, as in the amended model, or 75%;
- whether a state insurance commissioner should have greater discretion to determine collateral posting requirements for certified foreign reinsurers independent of the sliding scale;
- whether review of affiliate transactions provided for in the amended models is necessary in light of the other provisions for review of affiliate transactions in other NAIC model laws and regulations, including the NAIC Insurance Holding Company System Model Act;
- whether the additional mandatory contractual provisions are necessary, given that reinsurance transactions are typically business-to-business transactions that do not necessitate the contractual protections of conducting business with individual policyholders; and
- whether, in respect of the factors a state insurance commissioner must consider in determining the qualified jurisdictions for certified foreign reinsurers, criteria should be changed from reciprocal recognition by a non-U.S. jurisdiction to treatment of U.S. reinsurers by a non-U.S. jurisdiction that is at least as favorable as treatment of that jurisdiction’s reinsurers by the U.S. domiciliary state.

The Reinsurance (E) Task Force welcomed these comments and suggestions, and announced that it planned to hold a public hearing in May to discuss changes to the Credit for Reinsurance Model Law and Regulation that would reflect these and other considerations.

DODD-FRANK RECEIVERSHIP IMPLEMENTATION

The Dodd-Frank Receivership Implementation Working Group (the "DFRI Working Group") of the Receivership and Insolvency (E) Task Force held its first open session at the Spring Meeting. The DFRI Working Group has been charged with the task of "receivership planning" in the event that an insurance company is subject to a liquidation proceeding under Title II ("Title II") of the Dodd-Frank Act. The DFRI Working Group has also been charged with monitoring the Title II rule-making process and commenting on proposed rules.

The DFRI Working Group approved a preliminary outline of items for its consideration (the "Process Issues Outline") that had been exposed for initial comment in advance of the Spring Meeting. The Process Issues Outline identifies four areas for the DFRI Working Group to consider:

- state-level processes to ensure that the state receivership mechanism will respond effectively to an insurance company liquidation under Title II;
- issues relating to the treatment of insurance company subsidiaries and affiliates in the event of a liquidation of a financial company under Title II;
- national coordination initiatives to ensure that there is support for the designated state receiver; and
- potential changes to state laws and regulations.

A regulator subgroup from Ohio has been assigned responsibility for drafting procedures for the prompt initiation of state receivership – essentially, an "emergency manual" in the event of a Title II liquidation. The subgroup will develop a checklist of steps and considerations to expedite the receivership process and ensure coordination among governmental authorities. Another regulator subgroup from California and Connecticut has been assigned responsibility for developing an outline of issues relating to the treatment of insurance company subsidiaries and affiliates in a Title II liquidation. The regulator subgroups were asked to have initial drafts prepared by the end of April, so that a complete draft would be available for discussion at the NAIC's next national meeting.

The DFRI Working Group also raised a couple of legal drafting issues for consideration: (1) whether a federal determination of a financial company's systemic risk should be automatic grounds to initiate a state receivership of an affiliated insurer, and (2) whether state law should expressly provide for an expedited receivership process for affiliated insurers of financial companies subject to federal determinations of systemic risk. (We expect that the legal drafting

issues that the DFRI Working Group intended to raise were (1) whether a financial company being placed in orderly liquidation under Title II of the Dodd-Frank Act should be automatic grounds to initiate a state receivership of an affiliated insurer, and (2) whether state law should expressly provide for an expedited receivership process for affiliated insurers of financial companies that are placed in orderly liquidation.) The DFRI Working Group stated that it is not ready to opine on these issues; however, it has asked Texas to comment on these issues, as a bill has been filed in the Texas legislature to make changes in that state's receivership act that are intended to conform to the Dodd-Frank Act.

THE COMMON FRAMEWORK FOR THE SUPERVISION OF INTERNATIONALLY ACTIVE INSURANCE GROUPS

At the Spring Meeting, the Group Solvency Issues (EX) Working Group (the "GSI Working Group") discussed the ongoing issue of possible means by which state insurance regulators could monitor the combined capital adequacy of all entities within an insurance holding company system, including recent efforts by the International Association of Insurance Supervisors (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. The GSI Working Group is working to provide comments to the ComFrame Task Force at IAIS by July 1, 2011 as part of the effort to develop guidelines for identifying internationally active insurance groups and resolving jurisdictional issues.

One issue which the GSI Working Group plans to discuss prior to the 2011 Summer National Meeting is the scope of ComFrame, and whether the system should be generally applicable to supervision of insurers, or whether it should focus on the characteristics that are unique to internationally active insurance groups. The GSI Working Group also addressed the concern that ComFrame would impose burdens on companies that have immaterial international operations, and stated that it intended to focus on activities of only the largest insurance groups. In response to the concern that some ComFrame provisions would not be consistent with the NAIC's principles of individual state autonomy, the GSI Working Group stated that, given the uniqueness and complexity of large insurance group issues, ComFrame should focus on general

principles and high-level concepts, rather than specific compliance issues and capital requirements that more likely would be a source of conflict.

SUPERVISORY COLLEGES

The GSI Working Group also discussed supervisory colleges, noting that U.S. regulators currently participate in supervisory colleges, and that the amendments to the Insurance Holding Company System Model Act approved at the NAIC December 2010 Plenary Meeting provide 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. To promote the participation of U.S. insurance regulators in supervisory colleges for internationally active insurance groups, the GSI Working Group has developed a web-based request form through which international regulators can request the participation of their U.S. counterparts. The GSI Working Group also discussed recommendations to develop a centralized database for regulators to locate information on supervisory colleges. One concern in the discussion of supervisory colleges was that non-U.S. counterparts may have a concept of "lead coordinator" or "group supervisor" with individual, centralized decision-making authority that is not consistent with the NAIC's system of "lead regulators" and consensus decision-making. The GSI Working Group stated that it would continue to insist on group decision-making in supervisory colleges, and that it would emphasize that a group supervisor of a supervisory college should have primarily a coordinating, rather than decision-making, function.

INTERNATIONAL SOLVENCY INITIATIVES

At the Spring Meeting, the International Solvency (EX) Working Group (the "IS Working Group") convened to discuss the NAIC's draft proposal for a U.S. Own Risk Solvency Assessment ("ORSA"), which the NAIC had exposed for comment on February 11, 2011.[2] 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 by an insurance company in accordance with prescribed regulatory criteria, in order to assess the adequacy of capital levels in light of the insurance company's unique business mix and strategy.

The NAIC's ORSA proposal would require an insurance company to produce, at the legal entity level, an ORSA document comprised of three major sections:

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2 *The proposal is available on the NAIC's website at http://www.naic.org/documents/committees_ex_isftf_exposures_orsa.pdf*

- Section 1 – Description of the Risk Management Policy, detailing the company's risk management policy and all relevant and material risk categories and describing how those risk categories are managed on a day-to-day operational basis;
- Section 2 – Quantitative Measurements of Risk Exposure in Normal and Stressed Environments, setting forth the results of quantitative modeling for each risk category under normal and stressed conditions; and
- Section 3 – Prospective Solvency Assessment, describing the adequacy of the company's financial resources to execute the company's three-to-five year business plan.

The NAIC expects that the Group Solvency Issues (EX) Working Group will also develop a Section 4 – Group Solvency Assessment or propose modifications to Section 3 to incorporate a group capital assessment.

During the Spring Meeting, the IS Working Group heard from a number of interested parties regarding various aspects of the NAIC's ORSA proposal, including with respect to: (1) the confidentiality of ORSA documents and models, which several interested parties emphasized would be critical to preserving insurance companies' competitive advantages since such documents and models would contain competitively sensitive and forward-looking information; (2) the inclusion of prescriptive requirements in the proposal, which several interested parties believed to be inconsistent with the concept of ORSA as a means to assess insurance companies' internal risk management processes; (3) the NAIC's proposal to conduct the ORSA at the legal entity level, given – as several interested parties noted – that most insurance companies conduct their risk management processes at a group level and that the solvency of an individual member of a group is often heavily dependent on the solvency of the group; (4) the need for proportionality in designing ORSA requirements, as several interested parties observed that insurance companies vary widely in their size, business models and levels of complexity and risk; and (5) the frequency of reporting requirements, given the significant administrative burden and costs that would be involved in preparing ORSA documents.

The IS Working Group also discussed its plan to hold, together with the Corporate Governance (EX) Working Group, an interim meeting in late May or early June to discuss enterprise risk management ("ERM") and corporate governance issues. At the interim meeting, insurance companies will be invited to present their ERM processes to regulators in confidential, closed-door workshops. The IS Working Group noted that it has received many requests from insurance companies to participate in these workshops and will continue to accept requests, but it will not be able to accommodate all of them.

CORPORATE GOVERNANCE OF INSURERS

At the Fall 2010 NAIC National Meeting, the Corporate Governance (EX) Working Group asked NAIC staff to create an outline of key corporate governance principles for discussion among state insurance regulators and interested parties. The working group instructed that the outline should be based on certain IAIS "core principles" relating to corporate governance, recommendations from the International Monetary Fund's May 2010 Financial Sector Assessment Program Report and the NAIC's own summary comparison of corporate governance and risk management standards imposed by various international insurance regulators.

In January 2011, the working group released for comment summaries of existing state corporate governance law, the aforementioned summary of corporate governance principles and standards in place in Australia, Canada, Switzerland and the U.K. and under the Code of Conduct of the Bermuda Monetary Services Authority. The working group indicated that the high-level corporate governance principles it was developing were aimed at helping U.S. regulators "achieve substantial compliance with the IAIS core principles without placing an overly excessive burden on the insurance industry."[3] The working group presented the result of these efforts, its White Paper on High-Level Corporate Governance Principles for Use in U.S. Insurance Regulation ("White Paper"), at the Spring Meeting.

The White Paper is organized into twenty corporate governance principles that are in turn supplemented by more detailed guidance. The principles are described as being "essential, high-level requirements necessary for an insurer to provide minimum levels of consumer protection and capital adequacy." The guidance accompanying each principle is intended to provide detail regarding how an insurer can best comply with such principle. According to the White Paper, these "principles of proportionality" are meant to be applied in a manner proportionate to "the nature, scale and complexity" of an insurer.

The principles are themselves divided into eight categories, briefly summarized as follows:

- **Corporate Governance.** Specifies the broad scope of the framework that an insurer's corporate governance system should encompass.

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[3] *See the NAIC's "White Paper on High-Level Corporate Governance Principles for Use in U.S. Insurance Regulation," available for download at* http://www.naic.org/meetings1103/summary_ex_smi_corp_governance.htm

- **Board of Directors.** Outlines the duties and responsibilities of board members, the skills and knowledge they should possess and the type of compensation policy that should be implemented by the board.
- **Senior Management.** Describes the role and responsibilities of senior management with respect to the day-to-day operations of the insurer and its interaction with the board.
- **Suitability of Individuals.** Identifies and defines the traits of "competence" and "integrity" as critical qualities that board members, senior managers, and other key persons (including significant owners) of an insurer must possess.
- **Reporting and Transparency.** Describes the responsibilities of an insurer to maintain an effective financial reporting process and to disclose material information about its governance processes with regulators and relevant stakeholders.
- **Risk Management and Internal Control Systems.** Describes the obligation of an insurer to implement systems capable of identifying and managing material risks and monitoring compliance with the insurer's key policies and procedures.
- **Control Functions.** Specifies that an insurer's control functions, whether internally maintained or outsourced, must be capable of managing risks, ensuring compliance with the insurer's legal and regulatory obligations and supporting the insurer's actuarial and internal audit processes.
- **Regulatory Oversight.** Acknowledges the authority of regulators to require an insurer to demonstrate the effectiveness of its corporate governance framework and remedy any identified deficiencies.

In presenting the White Paper, the working group chair cited as further justification for creation of a formal corporate governance framework (1) the commitment to the G-20 by the United States to achieve compliance with the IAIS core principles and (2) the necessity of adhering to the recommendations of a bipartisan congressional committee formulated as a response to the financial crisis.

Objections to the White Paper were voiced by several industry associations and followed on from comments received to the summaries released by the working group in January. The representative of the National Association of Mutual Insurance Companies expressed what appeared to be the overarching concern of industry, namely, that the principles had been

developed without identification or discussion of the regulatory defects they were purporting to address. Parties also expressed concerns about potential conflicts with state law and whether the end result would require updates to model laws.

The working group voted to expose the White Paper to a 45-day public comment period. As noted at the outset of the White Paper, the working group's next charge is to determine the changes to the insurance regulatory structure needed in order to evaluate adherence to these corporate governance principles.

STRANGER-ORIGINATED ANNUITY TRANSACTIONS

In September 2010, the NAIC's Life Insurance and Annuities (A) Committee (the "A Committee") released for comment an initial draft of a model insurer bulletin to address regulatory concerns about transactions in which agents or investors offer terminally ill individuals a nominal fee to act as the measuring life on an annuity. These transactions are known as stranger-originated annuity ("STOA") transactions. Comments were received from a substantial number of interested parties, and at the Fall 2010 NAIC National Meeting, the A Committee charged a new subgroup with preparation of a revised draft of the model insurer bulletin for further review and consideration.

At the Spring Meeting, the A Committee presented the revised bulletin (now a "sample bulletin") and voted to approve it for adoption. Among the more significant changes to the bulletin were:

- a suggestion that companies review applications with regard to the health status of annuitants was dropped, in response to objections on the grounds that annuities are not typically medically underwritten;
- recommending a review of a company's chargeback policies only if annuitization or payment of death benefit occurs in the first policy year *and* there are additional facts indicating that the annuity contract was part of a STOA transaction (e.g., the contract owner and annuitant are not the same); and
- encouraging companies to report both actual and potential STOA transactions to regulators.

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 2010 Fall National Meeting, the A Committee exposed for comment changes to the Model Disclosure Regulation adopted by the Annuity Disclosure Working Group. These changes included, among others, (1) broadening the scope of the Model Disclosure Regulation to include variable annuities and other registered products, (2) enhancement of the disclosure requirements for indexed annuity products and (3) specification of standards that govern the use by insurers of illustrations in the sale of annuity products.

Numerous interested parties provided comments on the proposed revisions to the Model Disclosure Regulation, and an updated draft intended to address some of the issues raised was presented for consideration at the Spring Meeting. Key modifications were:

- required disclosure of an illustration of potential values of the non-guaranteed elements of an annuity, such as those governing the use of low- and high-value scenarios, have been clarified and expanded; and
- the text for a newly-required performance disclaimer statement that must accompany a fixed index annuity illustration was specified.

Several third parties expressed concern that the provisions describing the circumstances under which a purchaser of an annuity must be presented with a Buyer's Guide were confusing. Nonetheless, these provisions were left intact. Following discussion of the changes, the Annuity Disclosure Working Group voted to expose the revised draft for a two-week comment period.

PRINCIPLE-BASED RESERVING AND CAPITAL STANDARDS FOR LIFE INSURERS

At the Spring Meeting, the Principle-Based Reserving (EX) Working Group (the "PBR Working Group") met to discuss the continued work of the Life and Health Actuarial Task Force ("LHATF") 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, considerable work remains before principle-based reserves can take effect.

A significant focus for LHATF is the impact study being conducted by Towers Watson, which analyzes 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 selected Towers Watson to act as a consultant in connection with the impact study

following the 2010 Fall National Meeting, and 41 companies are participating in the impact study by testing the proposed principle-based methodology on their internal data.

Towers Watson reported on the status of the impact study at the Spring Meeting. The majority of companies participating in the impact study have not yet provided the requested data, delaying the progress of the impact study, phase one of which was originally scheduled to be completed by March 31, 2011. Particularly, Towers Watson stated that it may not be able to disclose certain data it has received thus far for concerns that such disclosure could violate confidentiality (with respect to certain products) of participating companies due to insufficient depth of data. Towers Watson expected the final report to be delayed up to two months, but affirmed that it would provide a preliminary draft of the report on phase one of the study for exposure to the LHATF and PBR Working Group by the original deadline of June 30, 2011.

During the Spring Meeting, LHATF also discussed 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. The LHATF presented a white paper to the PBR Working Group defining the goals of the feedback loop with respect to principle-based reserving and data collection.

The white paper divides principle-based reserving and data collection into several phases which are to be implemented over several years. Phase one of the process will be the valuation of life insurance policies through the collection of experience data related to life insurance policies (i.e., mortality, policyholder behavior and expenses). Within the next month, New York will begin a phase one pilot program, instituting a mandatory collection process for mortality data from its regulated life insurers through a statistical agent. In that regard, the PBR Working Group also exposed for comment a draft letter to the Executive Committee on the NAIC's role regarding the statistical agent process, recommending that the NAIC should require all states to use one statistical agent for each specific study and that the NAIC should select and contract with that agent.

Phase two of principle-based reserving and data collection will be the implementation of stress testing. Future phases of principle-based reserving and data collection might include the annuity and accident and health blocks along with company (but not necessarily product-specific) data related to asset performance, market exposure and liquidity.

RISK-BASED CAPITAL CALCULATIONS FOR LIFE INSURERS

During the Spring Meeting, the Risk Based Capital (E) Subgroup (the "RBC Working Group") convened to discuss, among other things, the ongoing work of the American Academy of

Actuaries (the "AAA") on safety level calibrations embedded in the NAIC's risk-based capital formula ("RBC Formula") and the Capital Initiatives Working Group (the "CIWG") assessment of regulatory capital levels using internal models.

The RBC Working Group and the Life Capital Adequacy Subcommittee (the "Subcommittee") received the ninety-page report submitted by the AAA addressing the aggregation of safety level calibrations in the RBC Formula and the identification of any risks which might be missing from the RBC Formula (including a consideration of which of those risks might be quantifiable and merit inclusion in the RBC Formula).

The segment of the report presented to the Subcommittee noted that a safety level calibration for aggregated life risk based capital amounts is difficult to ascertain, as the original RBC Formula was designed to address four separately defined risk categories (as subsequently modified) and was not designed to achieve a stated calibration level or maintain capital requirements at a stated calibration level as an outcome of the RBC Formula calculation.

Additionally, the Subcommittee informed the RBC Working Group that, while certain risks are not reflected in the RBC Formula, no material risks or significant risk mitigation practices are being excluded from the RBC Formula. This is due to the fact that in the life business, risk based capital is largely an add-on to the considerable statutory reserving requirements, and exists mostly to capture risks which fall on the outer tail of risk distribution. The Subcommittee noted, however, that one such risk that might not be captured by the RBC Formula was liquidity risk, but that this risk is not the type of risk which can be properly addressed by pre-funded capital. Proposals for next steps were discussed but not resolved.

The RBC Working Group next received a preliminary report from the CIWG containing recommendations on the use of internal models for the determination of minimum regulatory capital requirements. The CIWG is in the process of developing modeling criteria which would, among other things, adequately account for both statutory and IFRS accounting principles, Solvency II and the impact of certain hedging strategies in a simplified manner. The CIWG also recommended a model which allowed for stress testing in addition to stochastic capital adequacy testing techniques. However, while certain aspects of this report were disclosed by the RBC Working Group, the report itself was withheld pending the final review of the CIWG. Among the issues and difficulties identified in the creation of recommendations on modeling criteria were that (1) each insurer assesses it capital uniquely, and (2) the CIWG is comprised of large insurance companies, and recommendations based on their assessments may not be reflective of smaller insurers' policies and procedures. The CIWG expects to finalize its recommendations by June 30, 2011.

FDIC-GUARANTEED SECURITIES

The Valuation of Securities (E) Task Force (the "VOS Task Force") received a report from the NAIC's Securities Valuation Office ("SVO") recommending that certain FDIC guaranteed securities be fully exempted from the filing requirements of the Purposes and Procedures Manual ("P&P Manual") of the SVO. When acting in its capacity as the receiver of a failed bank, the FDIC guarantees certain financial instruments issued by special trusts to fund the purchase of the failed bank's assets. In reliance on advice from the SVO that such guarantees were indeed backed by the full faith and credit of the United States Government, the VOS Task Force voted to exempt such securities from SVO filing requirements.

GOVERNMENTAL SECURITIES RATING FRAMEWORK

The VOS Task Force also received a proposal from the New York State Insurance Department ("NYSID") to review and revise the framework for rating government securities contained in the P&P Manual. The NYSID submitted this proposal to clarify the framework and reduce common reporting errors going forward. Primarily, the NYSID recommended simplifying the analytical framework by consolidating the four "buckets" into which government securities are currently classified to the following two: (1) obligations of government agencies or instrumentalities backed by the full faith and credit of the U.S. Government, and (2) obligations of the government and government-sponsored enterprises the NAIC deems equivalent to an NAIC 1 designation. Additionally, the NYSID proposes a general update to bring the framework in-line with the current scheme of government agencies and securities, as the definitions in the current framework are outdated. The VOS Task Force moved to accept the proposal and exposed the proposal for a 45-day comment period.

WORKING CAPITAL FINANCE NOTES

The VOS Task Force also considered a joint report of Pacific Life, the SVO and the Nebraska Department of Insurance regarding the treatment of Working Capital Finance Notes ("WCFNs") as invested assets.[4] WFCNs are created when a buyer of goods (an obligor) accepts goods from a supplier and confirms that the obligation to pay contained in an invoice is a binding and enforceable payment obligation, and the supplier then transfers that obligation together with other similar obligations to a third party (such as an investing insurance company). The report proposes that WCFNs represent sound investments in short term obligations appropriate for the general accounts of insurance companies and WCFN revolving purchase

[4] *The report was also supported by letters submitted by Mutual of Omaha Insurance Company and the UNIFI Companies.*

programs (“WCFN Programs”) should accordingly be incorporated into the SVO P&P Manual for national consideration.

Pacific Life presented the report before the VOS Task Force contending that WCFNs are an attractive investment option for insurance companies. Though the market for such financing has traditionally been dominated by banking institutions, the market is arguably deep considering potentially all large retailers and manufacturers could be interested in WCFN financing. WCFNs generally have a maturity anywhere from 30 days to up to one year but can generate higher yields than commercial paper. Pacific Life noted that such WCFN Programs are potentially less risky than other forms of securitizations due to increased transparency; unlike a mortgage pool supported by many individual, unrelated and unverified payment streams, WCFNs are supported by several payment streams from confirmed obligations of one large, creditworthy obligor. Pacific Life concluded by proposing to work further with the Statutory Accounting Principles (E) Working Group (“STAP Working Group”) to further determine where a WCFN Program would fit into statutory accounting framework if approved.

The SVO submitted proposed text to add to the P&P Manual which would assign an NAIC rating designations to WCFNs through a two-step evaluation process. The SVO would first identify the credit ratings and NAIC designation of the obligor, and second, would assess the transaction structure, agreements and any special attributes. Only obligors whose credit ratings are designated NAIC 2 or better would be eligible to participate in a WCFN Program.

The VOS Task Force received the report and exposed it for a 45-day comment period, and additionally contemplated soliciting referrals on the issue from the STAP Working Group, the Blanks (E) Working Group and the Capital Adequacy Task Force. The STAP Working Group noted that it had already scheduled a conference call with Pacific Life to consider the appropriate treatment of WCFNs as admitted or non-admitted assets, and requested that Pacific Life provide more financial accounting analysis. The VOS Task Force intends to establish a subgroup to focus on WCFN and related issues upon the conclusion of the comment period and the STAP Working Group review.

CATASTROPHIC EVENTS IN JAPAN

At the Spring Meeting, the Property and Casualty Insurance (C) Committee heard a report (the “Report”) on the tragic consequences of the earthquake and tsunami that struck Japan on March 11, 2011. The Report discussed efforts to assess the overall damage and predict the economic costs to the insurance industry arising from the tremendous losses of life and property, damage to infrastructure and disruption of business.

Not surprisingly given the ongoing uncertainty regarding the extent of the radiation leaks from the damaged nuclear facilities, estimates of aggregate insured losses as provided by catastrophe modelers range widely, from $12 billion for damages attributable to both the earthquake and tsunami to $35 billion for losses from the earthquake alone. The Report mentioned that several insurers and reinsurers have disclosed estimates of their individual probable losses in amounts of up to $2.1 billion.

According to the Report, the Japanese property/casualty insurance market is dominated by Japanese insurers. It was noted, however, that the impact of the disaster would be felt even by insurers with no direct exposure to the Japanese market, as companies all around the globe face potential disruption to their supply chains that could lead to claims against business interruption policies.

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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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