NAIC 2011 FALL NATIONAL MEETING

November 14, 2011

To Our Clients and Friends:

The National Association of Insurance Commissioners (the "NAIC") held its 2011 Fall National Meeting from November 3 to November 6, 2011 in National Harbor, Maryland. This Client Update highlights some of the developments from the Fall National Meeting that are of particular interest to many of our insurance industry clients, including developments relating to: (1) adoption of amendments to the NAIC Credit for Reinsurance Model Law and Model Regulation, (2) consideration of what elements of the recently adopted amendments to the NAIC holding company model law and regulation will be made part of the NAIC accreditation standards, (3) development of the Own Risk Solvency Assessment Guidance Manual, (4) continued discussion of "ComFrame," (5) corporate governance of insurers, (6) solvency modernization, (7) Actuarial Guideline 38, (8) principles-based reserving for life insurers, (9) a new NAIC debt designation (rating) framework, (10) standards for NAIC Acceptable Rating Organizations, (11) receivership issues relating to separate accounts, (12) contingent annuities, (13) a new NAIC inquiry into captives and special purpose vehicles, and (14) working capital finance notes.

For purposes of this report, the NAIC Securities Valuation Office is referred to as the "SVO."

AMENDMENTS TO THE CREDIT FOR REINSURANCE MODEL LAW AND REGULATION (AND OTHER REINSURANCE DEVELOPMENTS)

Model Law and Regulation Amendments

The **Reinsurance (E) Task Force** presented for adoption the amended versions of the Credit for Reinsurance Model Law and Regulation (the "Amended Models") it has been developing over the past several months. The Amended Models contain several important changes from the existing models, including the elimination of regulations on reinsurance credit allowed a foreign licensed ceding insurer (in recognition that Dodd-Frank Act § 531 effectively preempts nondomestic state reinsurance credit rules) and the introduction of a new risk-based collateral regime for certified foreign reinsurers consisting of the (1) provision of state insurance regulators with new powers to certify a foreign unauthorized 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 in lieu of the long-standing

100% collateral requirements imposed on reinsurance ceded to unauthorized reinsurers; and (3) imposition of certain additional mandatory contractual provisions for reinsurance transactions with a certified foreign reinsurer. The Amended Models have been continuously the subject of vigorous comment by industry participants.

Despite initial concern that the Amended Models would be met with objection or delay from one or more Executive (EX) Committee members, certain last minute alterations to the Amended Models resulted in a consensus and the Amended Models were adopted unanimously by the Executive (EX) Committee and Plenary. The final Amended Models include a compromise on concentration risk, and require that all domestic ceding insurers notify their home state within 30 days after (1) ceding to any single assuming insurer, or group of affiliated assuming insurers, more than 20% of the ceding insurer's gross written premium in the prior calendar year, or after it has determined that the reinsurance ceded to any single assuming insurer, or group of affiliated assuming insurers, is likely to exceed this limit; and (2) reinsurance recoverables from any single assuming insurer, or group of affiliated assuming insurers, exceed 50% of the prior year's policyholder surplus. These are patterned after similar reporting requirements added by New York to its Regulation 20 effective January 1, 2011.

In addition, the last minute changes to the Amended Models task the NAIC with developing a list of qualified jurisdictions through its committee process and creating a new group to provide advisory support and assistance to the states reviewing foreign reinsurer certification applications. Only foreign reinsurers domiciled in qualified jurisdictions may obtain certification and thus benefit from the collateral reduction provisions, and a state insurance regulator determining whether to approve a jurisdiction as qualified must consider (but may not defer to) the list developed by the NAIC. Further, if a state insurance regulator approves a jurisdiction as qualified that is not on the list developed by the NAIC, that state insurance regulator must "thoroughly document" the criteria on which such a determination is based.

Other Reinsurance Developments

Looking forward, the **Reinsurance (E) Task Force** proposed charges for 2012 include the development of an NAIC process to evaluate reinsurance supervisory systems of non-U.S. jurisdictions and the formation of the above-mentioned new group to provide high-quality review of certification/collateral reduction applications and assistance to the states.

Responding to a referral from the Receivership and Insolvency (E) Task Force regarding the collection of reinsurance recoverables for insurers in receivership, the Task Force also adopted a proposed amendment to the insolvency clause provisions of the Credit for Reinsurance Model Law. Particularly, Section 14.A of the Model Law was amended such that, in order for credit to be granted for a reinsurance arrangement, the mandatory insolvency clause in the reinsurance

agreement must expressly stipulate that the reinsurance provided thereby is payable directly to the liquidator or successor of the ceding insurer without diminution, regardless of the status of the ceding insurer. However, the Task Force declined to include a mandatory contractual requirement in the Model Law regarding interest on overdue recoverables, as more discussion was necessary to determine if the Model Law was the appropriate vehicle to implement such a requirement. The Task Force further directed its staff to research existing state laws and to present a report at the Spring National Meeting in March 2012 on receivers' access to and enforcement options with respect to reinsurance recoverables.

ACCREDITATION STANDARDS FOR THE INSURANCE HOLDING COMPANY SYSTEM MODEL ACT AND REGULATION

The **Financial Regulation Standards and Accreditation (F) Committee** discussed the adoption of revised accreditation standards for states based on revisions to the Insurance Holding Company System Model Act and Model Regulation. These revisions were adopted by the NAIC in December 2010 in response to the perceived inadequacy of the prior Model Act and Model Regulation in permitting state insurance regulators to monitor the solvency of insurance holding company systems. The revised Model Act included: (1) required disclosure of enterprise risk reporting within the holding company system, (2) modifications to the requirements for transactions within an insurance holding company system, (3) clarifications regarding a state insurance regulator's authority to access books and records of insurance company affiliates, and (4) enhancements to the requirements for divestitures and disclaimers.

The Group Solvency Issues (EX) Working Group developed a Draft Proposal for Substantially Similar Provisions of the Revised Insurance Holding Company System Model Act (#440) and Regulation (#450) for the Committee's review. The Draft Proposal sets forth the significant elements of the revised Model Act and Model Regulation that the Working Group determined should be incorporated into the NAIC's accreditation standards, thus making it necessary for states to adopt the revisions, or substantially similar legislation or regulations, in order to remain accredited by the NAIC. The key revisions put forward in the Draft Proposal are:

- Filing requirements for the controlling person of a domestic insurer seeking to divest its controlling interest in the domestic insurer.
- Annual enterprise risk report requirement for the ultimate controlling person of a domestic insurer.
- Transaction standards for cost sharing services and management agreements.

- Notice to the state insurance regulator of amendments and modifications to affiliate agreements that were previously filed with the regulator on a "Form D," including tax allocation agreements, reinsurance agreements and modifications thereto, with a materiality threshold.
- Authority of the state insurance regulator to examine the domestic insurer and its affiliates to ascertain enterprise risk, including access to books and records and authority to compelling production.
- Inclusion of a concept of supervisory colleges.

The Committee approved the Draft Proposal to be put forward for a 30-day comment period, after which the Committee projects that the Draft Proposal will be exposed for a one-year comment period beginning January 1, 2012.

OWN RISK SOLVENCY ASSESSMENT (ORSA)

The **Group Solvency Issues (EX) Working Group** discussed the NAIC's draft proposal for an Own Risk Solvency Assessment ("ORSA") Guidance Manual, which the NAIC had exposed for comment on October 14, 2011. ORSA is a concept initially borrowed from the Solvency II regime in the European Union to assess the adequacy of an insurer's capital levels in light of the insurer's unique business mix and strategy. It would consist of internal modeling and stress testing, designed and conducted by an insurer in accordance with prescribed regulatory criteria. The purpose of the ORSA Guidance Manual is to provide guidance to insurers on how to conduct an ORSA to assess the adequacy of their risk management and solvency positions.

The ORSA Guidance Manual would require an insurer to produce, at the legal entity level, an ORSA document comprised of three major sections:

- Section 1 – Description of the Insurer's Risk Management Framework, detailing the insurer'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 – Insurer's Assessment of Risk Exposure in Normal and Stressed Environments, setting forth the results of quantitative modeling for each risk category under normal and stressed conditions, as well as qualitative assessments of risks that cannot be easily quantified.

- Section 3 – Group Risk Capital and Prospective Solvency Assessment, describing the adequacy of the insurer's financial resources to execute the insurer's prospective business plan, as well as a group capital assessment.

In response to comments and amendments put forward by industry participants, the Working Group made several changes to the ORSA Guidance Manual. Notably, the ORSA Guidance Manual was revised to include more discussion of qualitative assessment of risk in addition to quantitative measurement of risk; to remove certain terminology specific to life insurers, so as to make the ORSA Guidance Manual unambiguous in its general applicability; and to specify that an insurer's capital assessment process should be closely tied to its business planning, to allow for the longer and shorter business planning cycles of insurers of different sizes. The Working Group then adopted the ORSA Guidance Manual as amended and sent it to the Solvency Modernization Initiative (EX) Task Force for its review.

The Working Group also discussed legal implementation of an ORSA requirement through an amendment to Form B of the NAIC Insurance Holding Company System Model Regulation – the annual holding company registration statement required to be filed by controlled insurers with their domestic state insurance regulators. Participants voiced concerns about the uncertain confidentiality of information relating to the Form B in certain states, as well as the potential inadequacy of the Form B to require a group-wide ORSA, as the ORSA Guidance Manual intends. In addition to developing a legal mechanism for ORSA implementation, the Working Group is also working on recommendations to the Financial Condition (E) Committee relating to implementation. Such recommendations may include establishing an effective date for the receipt of the first ORSA Summary Report; considering a proposal to the Financial Regulators Standard & Accreditation (F) Committee to ensure uniform adoption of ORSA procedures among the states; and the development of a voluntary, confidential ORSA pilot program.

THE COMMON FRAMEWORK FOR THE SUPERVISION OF INTERNATIONALLY ACTIVE INSURANCE GROUPS (COMFRAME)

The **International Solvency and Accounting Standards (EX) Working Group** discussed the ongoing efforts of the International Association of Insurance Supervisors (the "IAIS") to promote cross-border regulatory cooperation in the supervision of internationally active insurers through the 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 Working Group discussed a summary report of the questions and comments received by the IAIS regarding ComFrame following the September 27, 2011 Technical Committee meeting in Seoul, South Korea. The Working Group generally echoed the concerns of the commentators, particularly with regard to how insurer groups were to be designated as Internationally Active Insurance Groups ("IAIG") and the creation of a dual framework for IAIGs and insurers without substantial international operations.

The Solvency Modernization Initiative (EX) Task Force also discussed ComFrame, acknowledging that it presents a burden to insurers and regulators alike. Noting that over 400 pages of comments were received on the ComFrame proposal, one member of the Task Force reported that even one IAIG falling under the jurisdiction of the insurance department he represented would put enormous pressure on its resources due to current funding constraints and likely result in a competition for regulatory resources between ComFrame and ORSA implementation (as discussed above). This concern was shared by several members on the Task Force.

CORPORATE GOVERNANCE OF INSURERS

The **Corporate Governance (EX) Working Group** of the Solvency Modernization Initiative (EX) Task Force exposed a paper entitled "Existing U.S. Corporate Governance Requirements."

The draft paper is intended to summarize the various powers in both current state and federal law through which regulatory bodies have the ability to enforce certain corporate governance principles. The draft paper summarizes the various existing laws into the following categories:

- Principle 1: Regulatory Reporting, Disclosure and Transparency
- Principle 2: Off-site Monitoring and Analysis
- Principle 3: On-site Risk-focused Examinations
- Principle 4: Reserves, Capital Adequacy and Solvency
- Principle 5: Regulatory Control of Significant, Broad-based Risk-related Transactions/Activities
- Principle 6: Preventive and Corrective Measures, Including Enforcement

- Principle 7: Exiting the Market and Receivership
- Other Non-Solvency Related Processes (e.g., unfair claims practices, examinations, suitability laws, etc.)
- Other Corporate Governance Standards/Requirements Outside of Insurance Regulation (e.g., Dodd-Frank, NYSE and NASDAQ rules, etc.)

According to a timeline released by the Working Group, once the draft paper is complete, the Working Group will begin identifying any gaps in the existing "U.S. regulatory structure," and will explore ways to address these gaps during 2012.

SOLVENCY MODERNIZATION INITIATIVE

The **Solvency Modernization Initiative (EX) Task Force** stated its intention to produce a comprehensive policy report to the Executive (EX) Committee by December of 2012, detailing and evaluating the work that the Task Force has accomplished over the past years. The report will serve as a reference and cornerstone, both in the U.S. and internationally, as to how the U.S. system addresses insurer insolvencies.

The **Capital Initiatives Working Group** presented *Using Stress Testing as a Supplement to RBC to Determine Minimum Capital Requirements* to the Task Force. The Working Group is in agreement with NAIC that a Solvency II-type approach is not necessary or appropriate in the U.S., and views U.S. risk-based capital supplemented by stress testing as an alternative framework to Solvency II. The Working Group further advocated stress testing for its ability to capture certain types of risks that are not otherwise accounted for with formulaic analysis and its potential to identify important risk capital needs not currently handled by the U.S. risk-based capital approach.

LIFE INSURERS – ACTUARIAL GUIDELINE XXXVIII

The **Life Insurance and Annuities (A) Committee** received a Statement on Actuarial Guideline XXXVIII ("AG 38") from the Life Actuarial (A) Task Force regarding the application of the Valuation of Life Insurance Policies Model Regulation ("Model 830") to certain universal life secondary guarantee ("ULSG") products. The Statement specifically addresses the calculation of reserves in connection with such ULSG products, determining that the correct application of AG 38 is to derive the "minimum gross premiums" that represent the lowest schedule of premiums a policyholder could pay for such a product to satisfy the secondary guarantee. Further, when a policy contains more than one secondary guarantee, Model 830 requires reserves to be calculated using the secondary guarantee that produces the greatest

reserves (and ignoring all other secondary guarantees). The Statement concluded that the requirements of Model 830 and AG 38 are clear and therefore no changes or clarification were required, but the Statement was not adopted by the Executive (EX) Committee. Rather than adopt the Statement, however, the Committee forwarded the Statement to the newly-established Joint Working Group of the Committee and the Financial Condition (E) Committee.

The Joint Working Group will initially be comprised of representatives from the insurance departments of Alaska, California, Florida, Iowa, New Jersey, New York, Tennessee, Texas and Virginia. The Executive (EX) Committee charged the new Joint Working Group to "work expeditiously to determine whether it is prudent and necessary to develop interim guidelines and/or tools to be utilized by regulators in evaluating reserves for [ULSG] products and, if so, to promptly develop such interim guidelines and/or tools." One of the tasks that the Committee envisioned the Joint Working Group undertaking was determining what legal effect the Task Force's Statement would have, whether it be deemed interpretive guidance or whether it would have the force of law.

LIFE INSURERS – PRINCIPLE-BASED RESERVING AND CAPITAL STANDARDS

The **Principles-Based Reserving (EX) Working Group** discussed the continued work of the Life and Health Actuarial Task Force on various topics relating to the principle-based reserving approach to regulation and capital standards for life insurers.

The main focus of the meeting was a progress report provided by Towers Watson on the impact study it is conducting on Valuation Manual-20 ("VM-20"). The impact study investigates the effect of proposed principle-based methodologies on the life insurance industry and compares them to current reserving methodologies. Life insurers participate in the impact study by testing the proposed principle-based methodology on their internal data. Towers Watson reported that, of the original 48 life insurer participants, results were obtained from 36 life insurers in phase one. There were no submissions from life reinsurance or index universal life participants. Phase two sensitivities were performed on a subset of the baseline established in phase one.

The results of the impact study have yet to be thoroughly analyzed, but Towers Watson reported that most of the results thus far have been in the expected range. For example, the exclusion tests are functioning properly. The summary impact of VM-20 on 5 years of business revealed that reserves for universal life with secondary guarantees ("ULSG") and term business usually decreased as the length of the level term increased. Aggregation analysis showed that running individual level term periods together generally resulted in a 25% decrease. One surprising selected sensitivity result from phase two for the mortality margin component analysis was that

"credibility blending with industry" had a large impact on ULSG minimum reserves. There were very few issues with the term results, but they are still being analyzed, including one large term player that had counterintuitive results. Additional research will be conducted on specific issues such as surprising credibility and mortality results, how reserves develop over time and certain tax inefficiencies. Towers Watson is currently working on areas for refinement and next steps for the impact study.

The Task Force also provided an August 18, 2011 draft report, but did not present it in detail. The report was in response to the request from the Working Group to provide a status report. According to the draft report, a maintenance process for the Valuation Manual has been created and the Task Force has developed proposed modifications to Standard Nonforfeiture Laws necessary to implement the valuation changes. Revisions to the principle-based reserving methodology are also necessary. Two other outstanding items are actuarial requirements and reporting requirements. All of these issues should be addressed by March 2012.

The report also contained responses to action items in various areas. Some of the noteworthy updates are briefly summarized as follows. The report confirmed the regulatory ability to require changes to a life insurer's booked reserves. It also described continuing work in the following areas: proposals for appropriate discounting methodologies and discount rates, specified situations where the use of insurance industry experience data is not required for valuation, how to an identify acceptable method for credibility while still allowing actuarial judgment, work on margin setting for assumptions, an appropriate level of aggregation for setting the reserve liability and the level of prudence for principle-based life reserves. New York State continues to conduct a pilot project involving the mandatory submission of mortality data, but this endeavor has been more expensive than anticipated. The Task Force is also still working on a high-level impact assessment of the expected change in liability values due to principle-based reserving, and reported that VM-20 requirements may need to be simplified in this area. In addition, principle-based reserves testing is being performed to re-calibrate capital requirements based on the overall levels of reserve liabilities. The Task Force continues to consider modifications to the reserve certification process and is still making adjustments to the financial examination process with regard to the establishment of reserve liabilities. Finally, the concept of a central process to compare the review processes of various states is part of the discussions of the "feedback loop."

SVO PROPOSED RECALIBRATION OF NAIC DESIGNATION (RATING) FRAMEWORK

The **Valuation of Securities (E) Task Force** considered a proposal from the SVO that the NAIC replace its current single credit risk framework (i.e., rating 1 through 6) with three distinct frameworks. Under the SVO proposal, the NAIC would adopt (1) a corporate debt security

framework with 10 risk categories, (2) a municipal debt security framework with two distinct risk gradation scales (one for general obligations and another for special revenue bonds), and (3) an asset-backed security framework with three distinct risk scales. These three distinct risk scales would apply to the following groups:

- Group A – business loans, aircraft leases, tobacco settlement loans and non-insured SBA loans.
- Group B – auto loans, student loans, credit cards and equipment leases.
- Group C – manufactured housing, mutual fund fees and healthcare receivables.

The impetus for the adoption of the proposal was the SVO's recently amended *Analysis of the Performance of NRSRO Credit Ratings and Implications of Statistics Associated with NAIC Designations*, which assessed NAIC Acceptable Rating Organization rated assets by performance and found significant disparity among the distinct asset-classes. Several interested parties, including the American Council on Life Insurers, have submitted responses to the SVO proposal to date. The Task Force was not willing to support the recalibration approach without further study, and referred the SVO report to the C-1 Factor Review Subgroup for analysis.

Any change in NAIC debt rating methodology may impact the capital that insurers must hold to support its invested assets as NAIC ratings determine the capital required under the risk-based capital formula and report. Furthermore, such a change may also impact insurer investment laws as some state insurer investment laws prescribe qualitative and quantitative investment limitations for permissible investments based on the current NAIC 1-6 rating criteria, including quantitative investment limitations for non-investment grade debt securities held by insurers.

NAIC ACCEPTABLE RATING ORGANIZATIONS

Although not on the meeting agenda, the **Valuation of Securities (E) Task Force** received a motion from one of its members that the Task Force revisit the requirement that a rating agency rate 10% of the insurance industries' invested assets to qualify as a NAIC Acceptable Rating Organization ("ARO"), which presents a high barrier to entry for smaller rating agencies. This requirement effectively prohibits smaller rating agencies from qualification as an ARO for NAIC purposes, despite the fact that such agencies may otherwise be qualified by the Securities and Exchange Commission as a Nationally Recognized Statistical Rating Organization. Specifically, the moving member argued that removing this requirement would "open the faucet" of competition, permitting more rating agencies to participate in the market and ultimately make a broader scope of investments available for insurers to include as admitted assets, as more otherwise unrated securities receive NAIC-qualifying ratings. While acknowledging that this was

a policy decision, the moving member urged the Task Force to take action, stating that the Task Force was tasked with making policy decisions and this was the next logical step in the series of small steps that the NAIC has taken "to reduce dependence on the big three rating agencies."

Other members of the Task Force expressed concern that the increase in breadth of AROs would entail increased costs to the NAIC and take a substantial amount of time to properly implement, as the methodologies used by additional rating agencies would have to be studied and understood in order to determine how such rating agencies' ratings or scores equate to SVO designations (particularly without historical basis for comparison). Additionally, the members indicated that any expansion of AROs should avoid "rating the rating agencies" and requested that the NAIC staff provide further guidance on how additional rating agencies and their respective ratings would be evaluated.

To commence this process, the Task Force moved to re-expose for comment the three staff reports submitted to the Task Force last October relating to the assessment, reliability and use of Nationally Recognized Statistical Rating Organization credit ratings until December 31, 2011, and to readdress this issue at the Spring National Meeting in March 2012.

LIFE INSURERS – SEPARATE ACCOUNT RECEIVERSHIP ISSUES

The **Receivership Separate Accounts (E) Working Group** discussed ways to improve guidance to regulators administering receivership of an insurer with separate accounts. A representative of the National Organization of Life and Health Insurance Guaranty Associations was present to discuss issues related to guaranty fund coverage of insurance policies supported by separate accounts in receivership. Ultimately, coverage of separate account products varies according to the language of the governing state law, and largely depends upon interpretation of which products are required to be supported by a separate account.

The Working Group exposed for comment (1) a memorandum on "Comments on Exposure of Life Actuarial (A) Task Force memorandum to Financial (E) Committee," and (2) drafts of proposed case studies of separate account receiverships.

The memorandum outlines issues relating to separate accounts, namely:

- Concern that separate accounts create a preferred class of policyholders when a block of policies that has substantial investment guarantees is segregated in a separate account, thus allowing an insurer to insulate assets from general account liabilities while still requiring assets to be maintained in a separate account sufficient to fund these liabilities.

- Interpretations of insulation, including an assessment of whether general account assets transferred into a separate account could be treated as insulated or instead a debt owed back to the general account and thus a general account asset for purposes of receivership.
- Assessment of whether guarantees are appropriate in a separate account and whether such guarantees have any advantage over general account protection.

The memorandum recommends that the Life Actuarial (A) Task Force take no action regarding receivership issues until these topics are reviewed by the Working Group. The Financial Condition (E) Committee also discussed and received comments on the memoranda. The American Council of Life Insurers noted that the issues raised in the memorandum from the Life Actuarial (A) Task Force could benefit from further discussion, and provided supplemental information on many of the issues. The National Organization of Life & Health Insurance Guaranty Associations responded to the memoranda and contended that many, if not all, of the issues identified had been previously addressed by NAIC.

The Working Group also released for comment theoretical case studies of insurer receivership scenarios that may serve as guidance for regulators dealing with receivership of insulated, non-insulated and hybrid separate accounts. These case studies and additional guidance are intended for eventual inclusion in the NAIC Receivers' Handbook.

LIFE INSURERS – CONTINGENT ANNUITIES

The **Life Insurance and Annuities (A) Committee** discussed the report presented by the American Academy of Actuaries Contingent Annuity Working Group regarding the classification and treatment of contingent annuities from an actuarial and risk perspective. Contingent annuities provide a guaranteed lifetime withdrawal benefit based on covered assets that are not owned by the insurer, and after a certain age, the purchaser can initiate periodic withdrawals from the covered assets in an amount up to a specified percentage of the guaranteed benefit base. When and if these withdrawals exhaust the covered assets, the life insurer begins making guaranteed lifetime income payments to the purchaser.

As a policy matter, the Working Group report maintains that contingent annuities are a beneficial product for consumers seeking to protect against outliving one's retirement assets ("longevity risk"). In this regard, contingent annuities are similar to guaranteed living withdrawal benefit ("GLWB") riders to variable annuity products, and raise similar suitability and disclosure issues. However, the novel contingent annuity product design has led to confusion among state insurance regulators and the industry regarding how such products should be treated for actuarial, risk and filing purposes, and some states have determined that contingent annuities

should be classified as a type of financial guaranty insurance product. The Working Group report disagrees with this result for several reasons – a contingent annuity does not insure the covered assets or protect against loss of the covered assets; rather, the contingent annuity provides insurance protection with respect to a specified lifespan by guaranteeing lifetime income payments following depletion of the covered assets while the purchaser is still living, irrespective of the performance of the covered assets. Although a contingent annuity provides certain protection against the market performance of the covered assets, it does not reimburse for a loss in the covered assets, and the Working Group report argues that the covered assets function much like a deductible, where the annuity only pays out if the cumulative lifetime income payments exceed the deductible.

The Working Group report ultimately determines that, due to the substantial similarities that contingent annuities bear to GLWBs, the basic regulatory framework in place for GLWBs can be applied to contingent annuities with little or no changes, including Actuarial Guideline XLIII for reserves and C-3 Phase II for risk-based capital. In presenting the report to the Committee, the Working Group emphasized that the life insurance industry has the expertise and resources to manage longevity risk, which further supports its conclusion that contingent annuities should not be treated as financial guaranty insurance.

Following the Working Group's presentation of its report, certain industry participants commented in support of the arguments and conclusions set forth in the Working Group report. However, one commentator expressed concern of the life insurance industry's ability to manage the market risk associated with contingent annuities, citing the New York Department of Financial Services decision to classify such products as financial guaranty insurance.

NEW CAPTIVES AND SPV USE SUBGROUP

The Financial Condition (E) Committee created the **Captives and SPV Use Subgroup** in order to address its new charge imparted from the Executive (EX) Committee: to study insurers' use of captives and special purpose vehicles to transfer third-party insurance risk in relation to existing state laws and regulations and establish appropriate regulatory requirements to address concerns identified in such study. The Executive (EX) Committee charge acknowledges that the appropriate regulatory requirements may involve modifications to existing NAIC model laws and/or generation of a new NAIC model law.

The Committee noted in open discussion that the intent of the new Subgroup is to review specific insurers and specific transactions, and, as such, will require a certain amount of regulator-to-regulator meetings that will be closed to the public. However, the NAIC's open

meeting policy will otherwise be observed with respect to discussions not covering specific companies and/or transactions.

WORKING CAPITAL FINANCE NOTES

The **Valuation of Securities (E) Task Force** continued its analysis regarding the treatment of Working Capital Finance Notes ("WCFNs") as invested assets. WCFNs 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). Pacific Life Insurance Company, the Nebraska Department of Insurance and the SVO presented a joint report to the Task Force which recommended WCFNs as sound investments in short term obligations appropriate for the general accounts of insurance companies and proposed text for incorporation into the SVO Purposes and Procedures Manual to provide for rating criteria WCFN revolving purchase programs.

The Task Force adopted the minutes of the Invested Asset (E) Working Group meeting held on October 17, 2011, which propose a "Work Plan" that will frame the broader discussion on WCFN programs. The American Council of Life Insurers and Pacific Life Insurance Company intend to continue their support of the Working Group and Task Force in connection with their review of the SVO proposal to treat WCFN programs as invested assets.

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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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