

CLIENT UPDATE

NAIC 2012 SUMMER NATIONAL MEETING

NEW YORK

Thomas M. Kelly
tmkelly@debevoise.com

Nicholas F. Potter
nfpotter@debevoise.com

Ethan T. James
etjames@debevoise.com

Eric R. Dinallo
edinallo@debevoise.com

John Dembeck
jdembeck@debevoise.com

Richard J. Goldberger
rjgoldberger@debevoise.com

Vincent J. Bianco
vjbianco@debevoise.com

Kevin J. Saponaro
kjsaponaro@debevoise.com

WASHINGTON

Amanda Greenwold Wise
agwise@debevoise.com

The National Association of Insurance Commissioners (the “NAIC”) held its 2012 Summer National Meeting from August 11 to 14, 2012 in Atlanta, Georgia. This Client Update highlights some of the developments from the Summer National Meeting that are of particular interest to many of our insurance industry clients, including developments relating to:

	<u>Page #</u>
(1) 2011 amendments to the Credit for Reinsurance Model Law and related accreditation standards	2
(2) Own Risk Solvency Assessment	4
(3) “ComFrame”	5
(4) Corporate governance	6
(5) Solvency modernization	7
(6) Actuarial Guideline 38	8
(7) Principles-based reserving for life insurers	10
(8) Receivership issues relating to life insurer separate accounts	12
(9) Contingent deferred annuities for life insurers	12
(10) A white paper on captives and special purpose vehicles	14
(11) The treatment of qualified financial contracts in insurance insolvency proceedings	16
(12) Securities valuation developments	16
(13) Risk-based capital operational risk	18

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

CREDIT FOR REINSURANCE MODEL LAW AND REGULATION AMENDMENTS – IMPLEMENTATION AND ACCREDITATION

Implementation of 2011 Amendments

The **Reinsurance (E) Task Force** received a report from NAIC staff summarizing the implementation of the revised Credit for Reinsurance Model Law and Regulation approved by the Executive Committee and Plenary at the 2011 Fall National Meeting. The purpose of the revisions is to allow for reduced reinsurance collateral requirements for non-U.S. licensed reinsurers that are licensed and domiciled in qualified jurisdictions. The NAIC staff report indicated that while to date just ten states have adopted the revisions, these states, which include New York, New Jersey, Florida and Delaware, represent 40% of gross premium written in the U.S. in 2011. Of these ten states, only New York and Florida have certified non-U.S. licensed reinsurers (predominantly Bermuda reinsurers) for eligibility for collateral reduction. An additional eight states have announced plans to adopt the revisions.

The Task Force also approved instructions for Forms CR-F and CR-S, which are applicable to reinsurers certified under the revisions. These forms are to be filed annually with the reinsurer's certifying state to meet information filing requirements under the revisions.

Accreditation Standard – Certified Reinsurers

At the 2012 Spring National Meeting, the **Reinsurance (E) Task Force** exposed for a 30-day comment period a new "Reinsurance Ceded to Certified Reinsurers" section to be added to the existing NAIC accreditation standard on reinsurance ceded. The standard incorporates key elements of the reduced reinsurance collateral rules for non-U.S. licensed reinsurers set forth in the 2011 revisions to the Credit for Reinsurance Model Law and Regulation.

The Task Force adopted the minutes of its May 2012 conference call in which it approved a revised draft of the standard for recommendation to the Financial Regulation Standards and Accreditation (F) Committee (discussed below). The revisions include a clarification that the reinsurance concentration risk notification provisions, which in general are triggered when a ceding insurer reinsures more than 20% of its prior year gross written premium, only apply in states that adopt the revisions. The Committee exposed the standard for a 30-day comment period and anticipates considering it for adoption with immediate effect at the 2012 Fall National Meeting.

In response to comments received from interested parties urging that all states be required to adopt the Model Act and Regulation revisions and the revised accreditation standard to ensure national uniformity in the treatment of reinsurance collateral, Task Force members reiterated that it has been its consistent position that adoption of the revised credit for reinsurance framework which includes the reduced collateral requirement by a state was optional. The Task Force Vice Chair emphasized that any state that does adopt reduced collateral requirements for certified reinsurers must do so in accordance with the Model Act and Regulation revisions in order to maintain NAIC accreditation. The Task Force agreed to revisit the issue of uniformity within three years.

Accreditation

The **Financial Regulation Standards and Accreditation (F) Committee** discussed adopting the 2011 revisions to the Credit for Reinsurance Model Law and Model Regulation as an accreditation standard that states could be required to implement in order to remain accredited by the NAIC. The Reinsurance (E) Task Force submitted the following recommendations to the Committee:

- Revisions to the key elements of the NAIC's reinsurance ceded accreditation standard with respect to reinsurance collateral reduction, modeled on the 2011 revisions to the Model Law and Regulation, should be adopted as an optional standard under the accreditation program.
- Revisions to the Model Law and Regulation not specifically related to reinsurance collateral reduction should be considered acceptable, but not required for a state to adopt to remain accredited.
- The Committee should consider waiving its normal timeline for adoption of the accreditation standard in order to avoid further delay in creating uniform standards related to the reinsurance framework.
- These proposed accreditation standards, if adopted, would not require any state to change its existing credit for reinsurance rules to include the reduced reinsurance collateral provisions in the revised Model Law and Regulation. Rather, any state that chooses to add the reduced reinsurance collateral provisions going forward would have to adhere to the 2011 Model Act and Regulation standards, including the notification requirements with respect to reinsurance concentration risk. As recommended, the Committee voted to waive its normal timeline for adopting an accreditation standard, exposing the 2011 revisions to the Model Law and Regulation for comment, with a goal of voting on the adoption of the reduced reinsurance collateral regime as an accreditation standard at the NAIC Fall National Meeting.

OWN RISK SOLVENCY ASSESSMENT (ORSA)

ORSA Model Act

The **Group Solvency Issues (E) Working Group** postponed adoption of the much-anticipated Risk Management and Own Risk and Solvency Assessment Model Act, a new NAIC model act that will provide states with a mechanism to require insurers to file an Own Risk Solvency Assessment (“ORSA”) evaluating the adequacy of the insurer’s capital levels in light of the insurer’s unique business mix and strategy. Prior to the meeting, the Working Group redrafted portions of the Model Act to streamline sanctions, protect the confidentiality of information submitted to the NAIC and third-party contractors in connection with the ORSA, and provide for submission of the ORSA to the lead state regulator of an insurance group. Additional drafting suggestions were accepted at the meeting to prohibit the NAIC or third-party consultants from storing the information shared in preparation of the ORSA and to clarify references to the ORSA Guidance Manual, which provides instructions for insurers on how to conduct an ORSA. The Working Group plans for a joint meeting with the Financial Condition (E) Committee to review the development of the Model Act before moving forward with adoption.

ERM Education Program and ORSA Feedback Pilot Project

The **Own Risk Solvency Assessment (E) Subgroup** discussed the draft glossary to its ORSA Guidance Manual, provided an update on the Enterprise Risk Management (“ERM”) Education Program and reported on the results of the 2012 ORSA Feedback Pilot Project. After some debate about refinements to the definition of “available capital” and the concept of “security standard,” the Subgroup adopted the ORSA Guidance Manual glossary unchanged, while acknowledging that interested parties and regulators would still be able to comment and suggest drafting changes going forward.

The ERM Education Program for state insurance department staff has begun, with the NAIC offering live and internet-based classes on the knowledge and skills that a state ERM specialists should have. Next steps will include familiarizing regulators more specifically with the ORSA program.

The Feedback Pilot Project was developed to allow state insurance regulators to provide feedback to the industry before the effective date of the ORSA summary report to be filed by insurers under the Risk Management and Own Risk and Solvency Assessment Model Act and to identify portions of the ORSA Guidance Manual that require clarification or amendment. The Subgroup reported that its members had reviewed 13 ORSA reports prepared on a voluntary, confidential basis by insurers. Eight of the ORSA reports were

considered complete. The Subgroup's feedback included four specific recommendations to insurers in preparing an ORSA report: (1) identify the basis for accounting; (2) explain the scope of the ORSA report, including which entities in the insurance group are included; (3) include a summary of material changes from the prior year; and (4) provide group risk capital in a comparative format, with the current year against the prior year. The Subgroup discussed additional recommendations, such as providing an explanation of how executive compensation is tied to risk management, that will be distributed in writing in the near future. The Subgroup plans to provide one-on-one feedback to the insurers that volunteered to submit their ORSA reports under the Pilot Project. The Subgroup will also draft recommendations for refinements to the ORSA Guidance Manual and Risk Management and Own Risk and Solvency Assessment Model Act based on its experience with the Pilot Project.

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 ("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"). The Working Group solicited comments from interested parties to the current draft of ComFrame, which are to be submitted to the Working Group no later than August 17, 2012 for review and inclusion in an NAIC comment draft. The comprehensive NAIC comment draft will be submitted to the IAIS on or before the August 31, 2012 comment deadline.

The Working Group also received an update from NAIC staff as well as a presentation and report from the American Council of Life Insurers ("ACLI") on the current status of the Insurance Contract project, which supports the Financial Accounting Standards Board ("FASB") and International Accounting Standards Board ("IASB") in the development of a unified, comprehensive accounting standard for all insurance contracts. Key differences remain between the FASB and IASB models:

- The IASB model uses two margins, risk and residual, whereas the FASB model uses one composite margin.
- The IASB model permits the premium allocation approach, whereas the FASB model requires the premium allocation approach.

- For IASB model purposes, acquisition costs include all costs of acquiring and fulfilling the insurance contract liability, whereas the FASB model includes only the costs associated with successful contracts.
- The IASB model allows for “unlocking” of the margin when underlying assumptions change, whereas the FASB model locks the margin regardless of changes in underlying assumptions.

While the ACLI stressed that its report is not an advocacy piece, the NAIC and the ACLI share the view that IASB and FASB should endeavor to bridge these divides, although both the NAIC and ACLI consider this unlikely in the near term. The NAIC and the ACLI also agree that certain differences (such as risk margins) are essential components of the accounting framework that will require deliberation and compromise to reach harmonization, while other differences (such as acquisition costs) are relatively immaterial and should not delay agreement on a consolidated approach. Failure to resolve these differences could result in increased costs to insurers that will have to maintain multiple accounting systems and will also add complexity and uncertainty to insurer accounting systems that will likely increase the potential that users misunderstand insurers’ financial statements.

The **Group Solvency Issues (E) Working Group** also invited additional comments on ComFrame. Some regulators voiced general concerns that aspects of ComFrame might be overly prescriptive in the context of U.S. insurance holding company regulation and might impede the effectiveness of supervisory colleges. The Working Group, in conjunction with the International Insurance Relations (G) Committee, invited additional comments on ComFrame by August 17, 2012.

CORPORATE GOVERNANCE OF INSURERS

The **Corporate Governance (E) Working Group** discussed the “Proposed Responses to Comparative Analysis” paper that the Working Group had compiled over a series of conference calls organized around seven corporate governance principles and focused on a comparative analysis of existing standards with international (IAIS) standards and best practices. The paper provides a high-level outline of proposed enhancements of insurer corporate governance based on these seven core principles:

- Regulatory Reporting, Disclosure and Transparency
- Off-Site Monitoring and Analysis
- On-Site Risk-focused Examination

- Reserves, Capital Adequacy and Solvency
- Regulatory Control of Significant, Broad-based Risk-related Transactions/Activities
- Preventive and Corrective Measures, Including Enforcement
- Exiting the Market and Receivership

Although the Working Group did not open the paper for substantive discussion at the meeting, there was nonetheless considerable objection (both at the meeting and in the minutes of the conference calls leading to the report) from industry representatives to the proposal for the development of a common template for assessing an insurer's corporate governance. As a procedural matter, commentators suggested, among other things, splitting the governance assessment template from the remainder of the proposal for review by a special subgroup and alternatively folding this requirement into the Own Risk Solvency Assessment framework to avoid duplicative insurer reporting requirements. The Working Group emphasized that the paper was a working draft assembled by a broad coalition of state insurance regulators and is meant as a sounding board to prompt and organize formal comment. The Working Group exposed the paper for a 45-day comment period, encouraging interested parties to organize comments around the seven core principles as outlined. The Working Group also adopted an updated timeline to permit for a further series of conference calls following the comment period and setting the Fall National Meeting as the goal for finalizing the governance proposal.

The Working Group also exposed its draft comments on the ComFrame corporate governance module and encouraged interested parties to provide any additional comments prior to August 17, 2012 at which time the Working Group will submit its comments to the International Relations (G) Working Group for inclusion in the NAIC comprehensive comments.

SOLVENCY MODERNIZATION INITIATIVE

In March 2012, the **Solvency Modernization Initiative (E) Task Force** released for comment a revised version of its 2010 white paper, "The U.S. National State-Based System of Insurance Financial Regulation and the Solvency Modernization Initiative". The white paper consists of four main sections:

- The United States Insurance Financial Solvency Framework, describing the U.S. insurance regulatory framework for solvency and the framework's core principles;
- U.S. Insurance Financial Regulatory Oversight, expanding on the U.S. regulatory framework and the mechanics of the processes in U.S. insurance solvency regulation;

- Market Regulation, providing an overview of financial and market regulation, a description of the insurance marketplace and considerations for insurance regulators; and
- Solvency Modernization Initiative, documenting the Solvency Modernization Initiative's self-review, improvements made to the Initiative and the reasoning behind changes by U.S. regulators in conjunction with the Initiative.

The Task Force received extensive feedback on the white paper, and several interested parties presented and expanded on their comments at the meeting. The American Academy of Actuaries asserted that the white paper did not sufficiently highlight the excellent track record of U.S. insurance regulation and offered to provide concrete examples of how existing risk-based capital adequacy rules have prevented insurers from experiencing financial distress (noting that such successes typically go unreported to the broader public). Counsel for the National Association of Mutual Insurance Companies was troubled by what it viewed as an overly-broad definition of corporate governance in the white paper. The Association observed that the definition refers to the accountability of an insurer to its "stakeholders" which implicates unrelated third parties and outside interests – a notion reflective of European-style corporate governance but falling outside the bounds of well-founded American legal principles that limit corporate governance duties to a company's owners only. The Reinsurance Association of America took issue with references in the white paper to reinsurance as having played a prominent role in prior large insurer insolvencies, and presented evidence that the historical contribution of reinsurance to insurer insolvencies is statistically insignificant. The Association also called for greater emphasis in the white paper on the on-site financial examination process as a unique element of the U.S. regulatory framework and a key factor in the ongoing stability of the U.S. insurance industry.

Task Force chair Missouri Commissioner John Huff expressed his appreciation to the presenters and encouraged the Task Force staff members to incorporate the comments received to the extent appropriate in the next draft of the white paper.

LIFE INSURERS – ACTUARIAL GUIDELINE XXXVIII (AG 38)

On July 17, 2012, the **Joint Working Group of the Life Insurance and Annuities (A) Committee and Financial Condition (E) Committee** released for public comment an Exposure Draft containing the Joint Working Group's proposed revisions to Actuarial Guideline XXXVIII ("AG 38") governing the statutory reserve requirements imposed on life insurers offering universal life with secondary guarantee ("ULSG") and term universal life products. The content of the Exposure Draft reflected the bifurcated approach to

reserving for in-force and prospective business previously agreed by the Joint Working Group, whereby each block is addressed separately for purposes of evaluating reserves adequacy.

The Exposure Draft added a new Section 8D to AG 38 that sets out two alternative options for calculating a life insurer's reserves for business in-force as of December 31, 2012. Under the first proposal, an insurer's required reserves are calculated to be the greater of the amounts determined using the insurer's existing methodology and a gross premium reserve determined according to a principles-based reserving methodology that involves projecting cash flows and related investment returns under a thousand different interest rate scenarios. The second proposal involves comparing reserves calculated in the traditional manner with a gross premium reserve determined using an analysis of projected cash flows and investment returns that incorporates the application of a single interest rate (namely, the maximum valuation interest rate for the year of issue of each policy).

The Exposure Draft also included a revised Section 8E to AG 38 that specifies the process for calculating reserves required to be held in support of ULSG business written on or after January 1, 2013. Broadly in line with the Statement on AG 38 issued by the Life Actuarial Task Force on November 1, 2011, Section 8E requires life insurers to determine required reserves by calculating the amount of "minimum gross premiums" that would satisfy the secondary guarantee. Except for certain ULSG product designs (such as policies that utilize a shadow account or compare paid accumulated premiums to minimum required accumulated premiums), minimum gross premiums are deemed to be the lowest schedule of premiums a policyholder could pay for a given ULSG product that would keep the secondary guarantee in force.

Industry participants offered extensive comments on the Exposure Draft, many of which were reflected in an August 3, 2012 letter to the Joint Working Group submitted by the American Council of Life Insurers. The primary concerns expressed by commenting parties included the following: (1) the scope of the proposed changes to the reserving methodology for in-force business in Section 8D is too broad and incorporates assumptions that are excessively conservative, (2) application of Section 8D to in-force business written prior to July 1, 2005 would be unduly burdensome, (3) the power to approve an insurer's reserving analysis granted to the Financial Analysis Working Group under Section 8E is inappropriate and could potentially erode the authority of the relevant domestic state insurance regulator, and (4) an implementation date for the new reserving rules of January 1, 2013 does not provide adequate time for insurers to modify their internal procedures and systems.

On August 8, 2012, the Joint Working Group hosted a conference call during which an update on the status of the Exposure Draft was provided. Participants were informed that the Joint Working Group was planning significant changes to the second proposal in Section 8D covering reserving for in-force business (described above). These include use of the published NAIC interest rate referenced in the Standard Valuation Law rate, which is subject to annual revision, as the assumed maximum reinvestment return interest rate rather than the interest rate in effect at the onset of a policy for its duration. For Section 8D reporting purposes, whether life insurers will be permitted to report their reserves calculations on an aggregate rather than seriatim basis remains an open issue. Acknowledging the insurance industry's concern that policy-by-policy calculations will potentially result in artificially high reserves, NAIC staff indicated that insurers will likely be permitted to report policy reserves in the aggregate, but will be expected to be able to support their calculations with policy-level detail that can be provided upon request. Participants were also told to expect only minor technical changes to Section 8E. Joint Working Group members reiterated their longstanding commitment to a January 1, 2013 implementation date.

The Life Insurance and Annuities (A) Committee and Financial Condition (E) Committee each adopted the report of the Joint Working Group, including the minutes of its August 8, 2012 conference call, and indicated that a revised Exposure Draft would be released in the coming days. A vote on adoption of the Exposure Draft is expected to be scheduled shortly thereafter.

LIFE INSURERS – PRINCIPLE-BASED RESERVING

The **Principles-Based Reserving (E) Working Group** received a progress report on the continued work of the Life and Health Actuarial Task Force ("LATF") on various topics relating to the principle-based reserving ("PBR") approach to regulation and capital standards for life insurers.

The LATF adopted Valuation Manual-20, the standard that sets out the PBR requirements for life insurer products, on August 2, 2012, although certain items identified by regulators and interested parties remain works-in-progress, which the LATF had categorized into short-term and long-term projects. The LATF has also created a subgroup to prepare a briefing document to package the Valuation Manual-20 with the Standard Valuation Law for presentation to state legislatures in 2013.

The Working Group received a presentation from the American Academy of Actuaries (which would also subsequently be submitted to the Financial Condition (E) Committee)

on PBR implementation and review, including processes for validation of PBR assumptions. The Academy emphasized the substantial scope of the undertaking and recommended that the Working Group provide guidance for the process of collecting and compiling experience data, which will ultimately need to be digested into “reasonable assumptions” for PBR review. Regardless of the PBR assumption review method that is selected (centralized/NAIC, regulator, peer review), the Academy recommended the Working Group explicitly set out the responsibilities of the reviewer.

The Working Group next received input from the American Council of Life Insurers (“ACLI”). Citing the lack of staff, resources and expertise at the state insurance departments (stating that only 18 states have actuaries on staff), the ACLI supports a hybrid system for the review of PBR assumptions – reviews would be conducted by peer reviewers, but the peer reviewers would receive training (or possibly certification) and written guidance from a centralized resource such as the NAIC.

Additionally, the ACLI submitted two comment letters in July 2012 requesting that certain issues in the Valuation Manual-20 be addressed prior to the industry supporting its adoption. The ACLI reported that the LATF had or was in the process of addressing many of its requests, including its recommendation that the LATF include a robust formal notice and hearing process for future revisions to the Valuation Manual-20, on which the ACLI will continue to support and collaborate with the LATF. The ACLI reported that its 60-day field testing of the Valuation Manual-20 would be complete in early September 2012, despite the LATF adopting the final version of the Valuation Manual-20 later than previously expected. Accordingly, the ACLI supported the submission of the Valuation Manual-20 to the Life Insurance and Annuities (A) Committee without waiting to first address the additional issues identified in its comment letters.

Tennessee Commissioner Julie McPeak stated that the ACLI’s comment letters inappropriately conveyed a “line in the sand” on the Valuation Manual-20 that indicated that the industry’s support was conditioned on the NAIC and the LATF addressing certain issues. Commissioner McPeak suggested that the entire PBR initiative should be viewed as an accommodation to the industry (*i.e.*, a flawed Valuation Manual-20 is still a better outcome for the industry than the current one-size-fits-all formulaic approach) and was disappointed by the lack of clear support from the ACLI. Additionally, Alabama Commissioner Jim Ridling suggested that the ACLI share the responsibility for the delayed adoption of the Valuation Manual-20 as the LATF had postponed adoption pending input from the ACLI.

In view of ongoing discussions regarding the latest draft of Valuation Manual-20, the Life Insurance and Annuities (A) Committee did not consider the Valuation Manual during the meeting as previously indicated. Instead the Committee met by conference call on August 17, 2012. During that conference call, Committee members of several states qualified their support for the adoption of the Valuation Manual by repeating concerns raised at the Summer National Meeting about the lack of staff and other resources required to adequately review and monitor PBR on an ongoing basis. Ultimately, the Committee voted to adopt the Valuation Manual, with two states abstaining and New York casting the sole dissenting vote.

LIFE INSURERS – SEPARATE ACCOUNTS

Receivership Issues

The **Receivership Separate Accounts (E) Working Group** received updates on the ongoing efforts to improve guidance to state insurance regulators administering the receivership of a life insurer with separate accounts. Coverage of separate account products varies according to the language of the governing state insurance law, and largely depends upon interpretation of which insurance products are required to be supported by a separate account. The Working Group focused on its undertaking to recommend to the Financial Condition (E) Committee what the term “insulated” should mean from an insurer receivership perspective in the context of a separate account.

Defining an “Insulated” Separate Account

The **Separate Account Risk (E) Working Group** reported on its review of separate accounts to determine what should qualify as insulated, which is centered on the role of variable products and evaluating what portions of those products should be included in separate accounts as insulated. The Working Group was not yet prepared to take a position on how to define “insulated” for insurer receivership purposes and will continue its review of separate account issues.

LIFE INSURERS – CONTINGENT ANNUITIES

The **Contingent Deferred Annuity (A) Working Group** continued its mandate from the Life Insurance and Annuities (A) Committee to evaluate the consumer protection and solvency issues related to contingent deferred annuities (“CDAs”). In order to carry out its mandate, the Working Group received presentations from (1) the Center for Economic Justice, (2) a panel of industry participants including Prudential, Great West and Transamerica, (3) NAIC staff, and (4) the Employee Benefit Security Administration.

The Center for Economic Justice requested that the recommendation that the Working Group presents to the Committee include substantive analysis of CDA products including specific examples of CDA fee structures, suitability of CDAs as opposed to other products, such as variable annuities with guaranteed living withdrawal benefits, and reserves. Primarily focusing on consumer protection, the Center expressed concern that (1) consumers would not be adequately informed that the consumer's net benefits of CDA products increase as a consumer's investments become riskier, and (2) if appropriately marketed, the incentive structure of CDA products would cause consumers to make risky investments and thereby concentrate risk in the insurance industry generally. The Center also requested more clarity on whether the fee structure for CDA products would further incentivize riskier investment allocation or, alternatively, incentivize less risky investments that reduce the net benefit of the CDA product to the consumer. In addition, the Center recommended a one-page disclosure for consumers that would clearly explain the pros and cons of CDA products and identify other comparable lifetime benefit income products. With regard to solvency, the Center highlighted that modeling for the market risk aspect of CDA products would likely prove more difficult than modeling for the longevity risk associated with such products.

The Working Group also received a report from a panel of industry participants, including Prudential, Great West and Transamerica. The panel emphasized that existing consumer protections with respect to the sales of CDA products are multi-layered and multi-faceted. CDAs marketed to consumers would be associated with registered funds and securities selected by the insurers, and as such, (1) the federal securities laws, including disclosure requirements, would apply, (2) the brokers selling such products would hold a securities license (for sales of the underlying investment product) as well as the appropriate insurance license required under state law, and (3) broker sales would be subject to FINRA suitability requirements. The panel committed to provide examples of current marketing materials to the Working Group, and the Insured Retirement Institute is working with the panel to produce a 10-page summary prospectus for such products. The panel noted that sales of group CDA products to ERISA-qualified plans and institutions are typically exempt from the federal securities laws, but these sales are between highly sophisticated parties with expert advisers, and the underlying contingent annuitants are adequately protected by the CDA purchaser's fiduciary duties that apply under ERISA. From a solvency perspective, the panel highlighted that 80% of all variable annuity products carry a similar guaranteed living withdrawal benefit, representing trillions of dollars of investments, and insurers offering these products survived the "real-life stress test" of the 2008 economic downturn. Therefore, the panel argued that existing reserving methodologies are sufficient.

The Working Group received an overview from the NAIC staff on the NAIC Model Suitability In Annuity Transactions Model Act and Regulation, which would apply to life insurers and CDA product brokers in states that have adopted such laws and regulations. The NAIC amended the Model Regulation in 2010 to conform to FINRA suitability requirements, and a safe harbor exists for annuity sales made in compliance with FINRA requirements. Annuity sales to ERISA-qualified pension plans are also largely exempted from the Model Act.

The Working Group next received a presentation from a representative from the Employee Benefit Security Administration on fiduciary duties that apply under ERISA to purchasers of group CDA products as well as the Administration's lifetime income initiative, which includes regulatory efforts to expand the application of ERISA fiduciary obligations to those offering investment advice to such purchasers. In addition, at the request of the U.S. Senate Special Committee on Aging, the U.S. Government Accountability Office is producing a report on the regulatory structures that apply to lifetime retirement income products, including CDAs, which the Working Group will consider in its recommendation to the Committee.

The Working Group did not have sufficient time to receive the last presentation on the agenda and will schedule an interim conference call to discuss the NAIC Standard Non-Forfeiture Law for Individual Deferred Annuities as it relates to CDA products.

CAPTIVES AND SPECIAL PURPOSE VEHICLES – WHITE PAPER

The **Captive and Special Purpose Vehicle Use (E) Subgroup** discussed the draft recommendations and conclusions to the white paper on Captives and Special Purpose Vehicles ("SPVs") that the Subgroup has been developing. The white paper has emerged from a Subgroup study of the use of captives and SPVs that began in response to concerns that the use of captives led to less regulation and had the potential to expose policyholders to greater risk. The much-anticipated recommendations and conclusions to the white paper include:

- Exploring alternative accounting treatment for life insurer XXX and AXXX reserves to address reserve redundancies at the ceding insurer level and reducing the incentive for ceding insurers to use captives for financing transactions.
- Establishing guidance for standardized review of transactions in which affiliate captives assume reserves from commercial insurers, to the extent such structures continue to be used.

- Considering re-evaluating and updating the NAIC Special Purpose Reinsurance Vehicle Model Act to encourage adoption and creating a more uniform framework for transferring risk to the capital markets.
- Supporting the International Association of Insurance Supervisors Guidance Paper on the Regulation and Supervision of Captive Insurers, which maintains that insurer-owned captives that are not used for self-insurance should be subject to the same regulatory framework as commercial insurers.
- Limiting the variability of qualified letters of credit and other security that may not offer sufficient protection intended in the NAIC Credit for Reinsurance Model Law and Regulation, including requiring enhanced disclosure in the ceding insurer's financial statements regarding the impact of captive transactions.
- Enhancing the ability of state insurance regulators to obtain information from a captive's regulator on a confidential basis to more fully understand the captive transaction.

One of the strongest concerns addressed by state insurance regulators was that captive transactions were being used by insurers to avoid the statutory accounting framework's reserve requirements. While there was acceptance in principle of using captives and SPVs to shift risk to the capital markets, regulators feared that captive reserve financing transactions would reduce the relevance of statutory accounting rules, including the development of principles-based reserving. Subgroup members said they preferred to see such captive transactions as the exception in reserve financing, rather than the rule, and for the statutory accounting framework to address any reserve redundancy issues within the ceding insurer itself, thus reducing the impetus to form captives for reserve financing purposes. Subgroup members agreed that insurance holding company analysis would have to be more thorough for state insurance regulators to adequately assess the effects of captive reserve financing transactions, such as those using parental guarantees as security, on an insurance group.

Acknowledging the need to reach a stronger consensus among regulators and to seek input from the industry, the Subgroup invited additional informal comments and delayed exposing the white paper for formal comment until further revisions can be made. The Subgroup hopes to make recommendations regarding the regulation of captives and SPVs to the Financial Condition (E) Committee by the end of the year, and noted that it would study market conditions and recommend that any transition on the treatment of captive transactions be gradual.

QUALIFIED FINANCIAL CONTRACTS – STATUS IN AN INSURER RECEIVERSHIP (IRMA SECTION 711)

The **Receivership and Insolvency (E) Task Force** discussed recommendations and requests from the Financial Condition (E) Committee in response to the recommendations in the Insurance Receivership Model Act (“IRMA”) Section 711 (E) Subgroup relating to IRMA Section 711. IRMA Section 711 governs the treatment of qualified financial contracts in an insurer insolvency. The Financial Condition (E) Committee’s recommendations to the Task Force included:

- Developing financial statement disclosures necessary to quantify the potential impact of IRMA Section 711.
- Clarifying what should be included in or excluded from the definition of “qualified financial contract” in IRMA to ensure proper disclosure.
- Drafting additional guidance for publication in the NAIC Receivers’ Handbook for Insurance Company Insolvencies, including guidance related to the legal intent of IRMA Section 711.
- Developing a model guideline to recommend to the states that a 24-hour stay provision, similar to such provisions in the Federal Deposit Insurance Act and Title II of the Dodd-Frank Act, be included when implementing IRMA Section 711.
- Developing training programs for the states with respect to IRMA Section 711.

The Task Force plans to develop the next steps based on these recommendations.

SECURITIES VALUATION DEVELOPMENTS

Reconciliation of Foreign Accounting Standards

The **Valuation of Securities (E) Task Force** received a letter from the American Council of Life Insurers (“ACLI”) requesting that the NAIC grant the SVO the authority to develop and maintain a list of countries exempt from the NAIC accounting reconciliation requirements. Currently, the SVO Purposes and Procedures Manual mandates that investments in issuers not reporting in either U.S. GAAP or IFRS be filed with the SVO accompanied by a reconciliation of local GAAP to U.S. GAAP or IFRS. Investments that do not comply with this mandate automatically receive an NAIC Designation of NAIC 5.

Citing the importance of investment flows from U.K., Australian, and Canadian issuers, which are each currently exempt from the NAIC reconciliation requirement, the ACLI emphasized that allowing the SVO to expand this exemption list to include other

jurisdictions with developed economies and private placement markets would allow insurers to further diversify their investment portfolios in a high-quality asset class.

The Task Force moved to expose the ACLI request letter for a 45-day comment period and specifically requested comments as to how the SVO should evaluate the list of countries and what resources might be necessary for the SVO to develop and maintain such a list.

Working Capital Finance Investments

The **Valuation of Securities (E) Task Force** continued its analysis regarding the treatment of Working Capital Finance Investments as invested assets. Working Capital Finance Investments 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 insurer).

The Task Force exposed for a 15-day comment period the Invested Assets (E) Working Group proposal for additional criteria and controls applicable to Working Capital Financial Investments and Working Capital Finance Arrangements, as was requested by the Statutory Accounting Principles (E) Working Group in connection with its correlated amendment to SSAP No. 20. The additional criteria and controls for Working Capital Finance Investments/Arrangements include, among other things, (1) a requirement that any Working Capital Finance Investment be supported by first priority perfected security interest, and (2) expanded authority and controls for SVO analysis and approval of participation structures and for non-U.S. based transactions.

Following the comment period and an interim call on the Working Group's proposal, the Task Force will refer the proposal to the Statutory Accounting Principles (E) Working Group as well as the Capital Adequacy (E) Task Force and Blanks (E) Working Group for review and input. Highlighting that the SSAP itself does not include quantitative limitations on an insurer's investments, Pennsylvania Deputy Commissioner Steve Johnson recommended that the Working Group develop a statement to the state insurance regulators to begin considering where such investments would fit under the respective state's insurer investment law.

SVO Proposed Recalibration of NAIC Designation (Rating) Framework

The **Valuation of Securities (E) Task Force** continued the discussion of a proposal to introduce an "S" suffix on the NAIC Designation of certain securities. The hope is that this

will clarify inconsistencies between the SVO Purposes and Procedures Manual and the NAIC Accounting Practices and Procedures Manual.

To accomplish this goal, the SVO staff presented a proposed amendment to the Purposes and Procedures Manual that would remove the current classification methodology and allow the SVO to apply the “S” suffix to securities that meet a particular NAIC Designation but present “other non-payment risks” not typically associated with that type of security. The SVO expects that its proposal would affect less than 200 securities in the NAIC database.

Industry participants expressed concern that this amendment to the Purposes and Procedures Manual would grant the SVO a great deal of discretion to determine “other non-payment risks” without any clear limit on what might constitute “other non-payment risks” or accompanying guidance for insurers to ascertain when the SVO would exercise this discretion. Commentators suggested that the proposal be amended to add clarity and transparency necessary to determine when and how an “S” designation would apply and to limit the application of “S” designations to securities that atypically feature defined and understood risks such as interest deferral risk and subordination risk. Further, industry participants suggested that, as an unintended consequence of this proposed amendment, insurers facing the uncertainty of this SVO discretion may instead increase reliance on the rating agencies for a more clearly defined issue-rating process, an outcome contrary to the NAIC’s ongoing work to reduce and avoid such reliance.

Given the industry opposition, the Task Force received a motion from Pennsylvania Deputy Commissioner Steve Johnson to delay action on the SVO proposal until a clear point/counterpoint analysis could be prepared and presented to the Task Force. However, the motion to defer action did not carry, and the Task Force instead moved to and did adopt the SVO proposed amendment to the Purposes and Procedures Manual.

RISK-BASED CAPITAL – OPERATIONAL RISK

The **Solvency Modernization Initiative Risk Based Capital (E) Subgroup** discussed the potential inclusion of operational risk in the risk based capital framework. Looking to the International Association of Insurance Supervisors Core Principles for guidance, the Subgroup recognized that certain risks, such as operational risk, were inherently difficult to quantify and could instead be represented by simple proxy, but that methods for quantifying such risks will likely improve over time. Kansas Chief Actuary Mark Birdsall suggested the Subgroup develop a two-stage process to evaluate whether such risk can be appropriately quantified, specifically with respect to new products: (1) identification and

collection of the relevant data, and (2) utilization of that information to define stress testing to quantify the associated operational risk. The NAIC staff and industry participants commented that the Own Risk Solvency Assessment (E) Subgroup and the Corporate Governance (E) Working Group are at an advanced stage of addressing operational risk within those frameworks, and that a prudent next step would be to solicit input from the Solvency Modernization Initiative (E) Task Force to determine whether there is additional appetite to address operational risk in the capital discussions. The Subgroup resolved to have a presentation on the current state of the art in quantifying operational risk at the Fall National Meeting and to decide the path forward at that time.

* * *

If you would like more information on these or other topics of interest, please contact an insurance industry lawyer named on the first page of this Client Update or any insurance industry lawyer at Debevoise & Plimpton LLP.

August 20, 2012