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Client Update
December 14, 2017

Client Update
NAIC 2017 Fall National Meeting

The National Association of Insurance Commissioners ("NAIC") held its 2017 Fall National Meeting from December 2 to 4, 2017 in Honolulu. This client update highlights developments from the Meeting of particular interest to many of our insurance industry clients, including developments relating to:

For purposes of this report:

- "ComFrame" means the Common Framework for the Supervision of International Active Insurance Groups.
- "EU" means the European Union.
- "FIO" means the Federal Insurance Office of the U.S. Department of the Treasury.
- "FSB" means the Financial Stability Board.
- "G-SII" means a global systemically important insurer.
- "IAIS" means the International Association of Insurance Supervisors.
- "RBC" means NAIC risk-based capital.

(1) LIFE INSURERS

Variable Annuities

The **Variable Annuities Issues (E) Working Group** held a four-hour session during which the NAIC's consultant presented the recommendations from the Quantitative Impact Study II ("QIS 2"), which propose revisions to the AG 43 and C3 Phase II frameworks for variable annuities. The recommendations, which reflect guidance from the Working Group, include new and modified proposals from the first quantitative impact study. Among the new proposals are recommendations to (i) use the VM-20 scenario generator for separate account returns, but recalibrated based on data from 1926 to 2016, (ii) calculate the Standard Scenario based on company-specific market paths (selected from a panel of standardized paths), (iii) use the Standard Scenario construct to govern model choices and actuarial assumptions only, via a reserve "add-on," and (iv) permit smoothing to be conducted on the C3 charge, but not on the Total Asset Requirement.

The Working Group exposed for public comment until March 2, 2018 the QIS II recommendations as well as proposed revisions to AG 43 and to the life RBC instructions addressing interest rate and market risk. The Working Group is allocating a full day of discussion of comments received at the 2018 Spring National Meeting (scheduled for March 24-27, 2018 in Milwaukee).

Interested parties raised concerns about whether the March 2 deadline provides sufficient time to submit comments in light of the complexity and scope of the recommendations. Participants also questioned the overall approach of calibrating the AG 43 standards for variable annuity reserves with the C3 Phase II standards for risk-based capital. Although this approach may reduce volatility and minimize complexity in calculating Total Asset Requirements, questions focused on whether calibrating variable annuity reserves with risk-based capital is consistent with the intent of the risk-based capital regime.

Suitability in Annuity Transactions

The **Annuity Suitability (A) Working Group** reviewed and discussed an initial draft of proposed revisions to the Suitability in Annuity Transactions Model Regulation and proposed to change its title to "Suitability and Best Interest Standard of Conduct in Annuity Transactions Model Regulation."

Among the new provisions is a requirement that insurers and producers recommend annuity products that are suitable for and in the "best interest" of the consumer, which is defined as acting in a manner that "puts the interest of the consumer first and foremost." The proposed draft clarifies that "best interest" does not mean that a recommended annuity product is the least expensive, has the highest interest rate or income payout rate, or is the single best annuity product available in the marketplace at the time of the annuity transaction.

The proposed revisions also impose an obligation on a producer to disclose cash compensation received above 3% and noncash compensation in excess of $100 per producer per year. In addition, a producer would be required to disclose all "material conflicts of interest" which are defined as a financial interest of an insurance producer , or the insurer where no producer is involved, that a reasonable person would expect to affect the impartiality of the recommendation, including financial incentives or rewards offered to or received by an insurance producer, or a direct interest or ownership in an insurer by an insurance producer or an immediate family member of an insurance producer.

The Working Group exposed the draft revisions for public comment until January 22, 2018. Prior to the 2018 Spring National Meeting, the Working Group plans to meet via conference call to review and discuss comments received by the deadline to present a draft of proposed revisions to the **Life Insurance and Annuities (A) Committee** for consideration at the 2018 Spring National Meeting.

Reinsurance

At the 2017 Summer National Meeting, the **Reinsurance (E) Task Force** adopted a proposal to include a prohibition against engaging in transactions designed to circumvent the purpose and intent of the Term and Universal Life Insurance Reserve Financing Model Regulation ("XXX/AXXX Model Regulation") as a "significant element" of the accreditation standard for the XXX/AXXX Model Regulation. The Task Force referred its findings to the **Financial Regulation Standards and Accreditation (F) Committee**, which voted on September 1, 2017 to expose the proposal for a 30-day public comment period.

At the 2017 Fall National Meeting, the **Financial Regulation Standards and Accreditation (F) Committee** voted to defer adopting the XXX/AXXX Model Regulation as an accreditation standard. The deferral resulted from NAIC staff advice that additional amendments likely will be needed to conform the XXX/AXXX Model Regulation to requirements of reinsurance provisions of the Bilateral Agreement between the United States of America and the European Union on Prudential Measures Regarding Insurance and Reinsurance, otherwise known as the "Covered Agreement."

The Covered Agreement eliminates reinsurance collateral requirements for EU reinsurers maintaining a minimum amount of "own funds" equivalent to $250 million and a solvency capital ratio of 100% under Solvency II. In addition, U.S. reinsurers maintaining a capital and surplus equivalent to €226 million with an RBC of 300% of Authorized Control Level are not required to maintain a local presence in the EU in order to do business in the EU.

Under the Covered Agreement, states have five years to implement the reinsurance provisions or face potential preemption by the FIO. The Task Force announced that it would request comments and hold a public hearing in New York City in February 2018 to consider and hear proposals about how states may satisfy this requirement, including potential amendments to the Credit for Reinsurance Model Law and Model Regulation. The Task Force stated that it was starting the process of gathering information and that it would be seeking comments and ideas.

Representatives of international reinsurers and an industry group requested that, although the Covered Agreement is limited to EU reinsurers, reinsurance collateral relief provisions ultimately adopted by states to comply with the Covered Agreement should be applied to reinsurers in non-EU jurisdictions (such as Bermuda or Japan) that have met the NAIC's qualified jurisdiction requirements or otherwise have comparable insurance supervisory regimes.

(2) PROPERTY/CASUALTY INSURERS

Big Data

At the 2017 Summer National Meeting, the **Big Data (EX) Working Group** discussed an initial draft of a proposed structure for the review of complex rating models for personal auto and homeowners insurance. The proposed structure is intended to provide resources to enhance states' ability to conduct technical analysis of, and data collection related to, their review of complex models used by insurers for underwriting, rating and claims. The Working Group determined to focus initially on models used for personal automobile and homeowner insurance rate filings.

During the 2017 Fall National Meeting, the Working Group noted that it had not received any written comments on the revised draft of the proposed structure and that it will issue a formal request for comments by January 12, 2018.

The Working Group continued its discussion of the current regulatory framework for the oversight of insurers' use of consumer data, including what consumer notification obligations should apply when consumer data is used by insurers and whether the use of certain data variables should be prohibited. Regulators considered whether consumer notification requirements that apply when the use of credit scores results in an adverse credit decision should also apply to an insurer's use of other consumer data that results in an increased rate or a refusal to issue coverage. In considering whether certain consumer data elements should be prohibited from being used by insurers, the Working Group decided to survey state insurance regulators to collect information on whether states have specific prohibitions regarding the use of certain data elements in underwriting and rating private passenger automobile insurance and homeowners insurance.

The Working Group also indicated that it will request that the **Casualty Actuarial and Statistical (C) Task Force** appoint a **Predictive Analytics (C) Working Group** to draft potential changes to the Product Filing Examiners Handbook to: (1) address best practices for regulatory review of predictive analytics and models used by insurers to justify rates;

(2) facilitate discussion among state insurance regulators regarding rate filing issues of common interest across states; (3) facilitate training and sharing of expertise through predictive analytics webinars; and (4) work with NAIC technical staff to identify software, databases and other technology that could be purchased or developed to assist analysis of predictive models.

Cybersecurity

The **Cybersecurity (EX) Working Group** heard a report on Congressional efforts to pass federal cybersecurity legislation. It was noted that recent large data breaches have spurred additional Congressional interest in this legislation, including robust support for federal preemption with respect to matters of cybersecurity. In light of the NAIC's adoption of the Insurance Data Security Model Law, the Working Group recommended that the Working Group be dissolved and its work folded into the **Innovation and Technology (EX) Task Force**. A consumer advocate noted that the Working Group decided to bifurcate its consideration of the Insurance Data Security Model Law so that it would separately work on breach notification requirements, which have been adopted, and consumer protections in case of a breach, which have not been addressed. The Working Group explained that its remaining charges, including consumer protections in case of a breach, would be undertaken by the Task Force.

(3) INTERNATIONAL INSURANCE ISSUES

U.S.-EU Regulatory Relations

On September 22, 2017, the U.S. Department of the Treasury and the Office of the U.S. Trade Representative signed the Covered Agreement, which addresses group supervision, reinsurance and the exchange of information between supervisory authorities. The Administration also issued a policy statement on the implementation of the Covered Agreement, which affirms the U.S. system of insurance regulation, including the role of state insurance regulators as the primary supervisors of the business of insurance. The NAIC expressed support for the Treasury's focus on state-based insurance regulation and stated that, over the coming months, it would study the Covered Agreement's impact on existing state insurance laws.

At the 2017 Summer National Meeting, the **Financial Regulation Standards and Accreditation (F) Committee** was expected to adopt as new accreditation standards the Corporate Governance Annual Disclosure Model Act and Model Regulation (the "CGAD Models") and the 2014 revisions to the Insurance Holding Company System Regulatory Model Act (the "Holding Company Model"), which provide for states to become designated to act as a group-wide supervisor of an internationally active insurance group. The Committee voted to defer adopting any new accreditation standards until there was greater certainty with respect to the impact of the Covered Agreement.

With the issuance of the policy statement and guidance from the Treasury, NAIC staff advised the Committee that the Covered Agreement should not have an impact on the CGAD Models because corporate governance standards are not within its scope. The Committee voted to adopt the CGAD Models as an accreditation standard effective January 1, 2020 (there were two dissenting votes). Approximately 19 states already have adopted the CGAD Models.

The Committee also discussed adopting the 2014 revisions to the Holding Company Model as an accreditation standard, which was also deferred at the 2017 Summer National Meeting. Although NAIC staff advised the Committee that the Covered Agreement should not have an impact on the amendments, it became clear that the amendments would serve as an accreditation standard only for the 18 states that currently have internationally active insurance groups and act as group-wide supervisors. Several states that do not have internationally active insurance groups (and do not expect to have them) expressed concern about being able to justify to their state legislatures the need to make amendments that will have no impact on their state. Other states pointed out that accreditation standards are intended to promote uniformity and should apply to all states. The Committee voted to defer action to allow NAIC staff to work with the members to propose guidance for states without internationally active insurance groups and to discuss this matter again during an interim conference call before the 2018 Spring National Meeting.

IAIS Activities

The NAIC welcomed IAIS Secretary General Jonathan Dixon, who succeeded to the office in November, to attend the meeting of the **International Insurance Relations (G) Committee**. Mr. Dixon noted that the IAIS has three key goals: (1) delivering on its current commitments to support a more stable financial system, including mitigating systemic risk and developing ComFrame, (2) being alert to emerging risks and opportunities, particularly in the areas of FinTech, cybersecurity and climate risk sustainability and (3) preparing to shift its focus to supporting and assessing global standards, such as the Insurance Capital Standard 1.0 ("ICS"). In addition, he noted that the IAIS is increasingly focused on emerging markets.

Mr. Dixon described several major work streams nearing completion. With respect to ComFrame, a public consultation on ComFrame in its entirety is expected in the middle of 2018, with the IAIS on schedule to deliver its final ComFrame in 2019. In its continuing effort to increase transparency, the IAIS has added to its website information about the status of the development of certain ComFrame material. In addition, the ICS was published for extended field testing in July 2017, with over 50 field testing volunteers participating. At the IAIS's annual meeting in November, there was agreement to implement the ICS in two phases: In the first phase (described as the "monitoring phase" that will last from 2020 until 2025), the ICS will be used for confidential reporting to the group-wide supervisor for discussion in supervisory colleges. In the second phase that will begin in 2025, regulators will be permitted to take action against insurance groups on the basis of their ICS results from the first phase.

Mr. Dixon explained that the IAIS continues its work on an activities-based approach and expects to publish an interim paper for consultation by the end of 2017, with comments due by February 2018. The IAIS expects to publish a final consultation paper on an activities-based approach by the end of 2018 and will hold a stakeholder meeting in January or February 2018. The IAIS is also developing its five-year strategic plan, with approval expected by the annual meeting in November 2019. The current set of strategic objectives is designed to expire at the end of 2019.

Mr. Dixon noted that the FSB decided not to publish a new list of G-SIIs in 2017 but encouraged the IAIS to continue its work in developing an activities-based approach, which may have implications for identifying G-SIIs and may be reviewed by the FSB in November 2018.

Finally, Mr. Dixon stated that the IAIS has developed a stakeholder engagement plan. The plan includes a publicly accessible 12-month schedule of major projects that indicates where stakeholder input will be sought. The plan also amends IAIS policies and procedures to incorporate a 30-day advance notice period for stakeholder meetings and a 7-day advance notice period for meeting materials. In addition, based on stakeholder feedback, the IAIS plans to extend the amount of time allotted for consultation and already extended the consultation periods for some outstanding consultations. In addition, the IAIS intends to undertake a review of its data management processes in 2018 in order to assess data duplication and quality.

It was noted that in 2018, the U.S.-EU Dialogue Project will focus on the use of big data, intra-group transactions and cybersecurity.

(4) LONG-TERM CARE INSURANCE

During the 2017 Summer National Meeting, the **Receivership Model Law (E) Working Group** voted to form a drafting group to propose revisions to the Life and Health Insurance Guaranty Association Model Act in connection with guaranty association assessment and coverage issues for potential long-term care insurance insolvencies. The Working Group agreed to focus on the adjustment of the allocation of guaranty fund assessments for long-term care insurer insolvencies among health, life and annuity accounts, and to consider inclusion of HMOs in the state guaranty fund system.

At the 2017 Fall National Meeting, the **Financial Condition (E) Committee** unanimously adopted amendments to the Life and Health Insurance Guaranty Association Model Act ("Model Act") to account for long-term care coverage. The process to develop changes to the Model Act was quick and included 12 conference calls and internal meetings in September and October with participation by interested parties.

Under the current Model Act, a life and health guaranty association is authorized to assess member insurers for amounts needed to discharge obligations with respect to a failed insurer, with assessments allocated to member insurers by accounts that correspond to lines of insurance business (i.e., life and health accounts). Thus, member insurers that write health insurance are assessed through the health account for a failure of a health insurer, and member life insurers are assessed through the life account for life insurer insolvencies. Because long-term care insurance is classified as health insurance in most states, a guaranty association's health account is assessed for long-term care insurance insolvencies even though most long-term care insurance is written by life insurers.

The proposed revisions to the Model Act include expanding the assessment base by adding life and annuity insurers to the health account for purposes of long-term care insurance insolvencies and splitting future assessments between member life and health insurers evenly. Under this proposal, life and annuity member insurers will be subject to assessments from the health account, and health and HMO member insurers will be subject to assessment from the life account.

The revisions also (1) add HMOs as members of a guaranty association, (2) grant explicit authority to guaranty associations to file for premium rate increases if they are actuarially justified and not prohibited by state law, and (3) clarify that the exclusion from guaranty association coverage of certain variable benefits under a life insurance policy or annuity contract does not apply to any portion of such policy or contract, including a rider, that provides long-term care or any other health insurance benefit.

A representative of a health insurer expressed opposition to the 50-50 split between life and health insurers because currently, long-term care insurance is written by a higher proportion of life and annuity insurers. Members of the committee and other interested parties noted that this issue had been addressed extensively during the development of the proposal and ultimately the Working Group decided not to tie the assessment to market share, which they said only presents a snapshot at a point in time.

(5) FINANCIAL STABILITY TASK FORCE

Macro-Prudential Monitoring

At the 2017 Summer National Meeting, as part of the NAIC Macro-Prudential Monitoring Initiative, the **Financial Stability (EX) Task Force** appointed a **Liquidity Assessment (EX) Subgroup** to review existing data related to liquidity risk, identify any data gaps based on regulatory needs, propose companies to which recommendations may apply and construct a liquidity stress-testing framework proposal for consideration by the **Financial Condition (E) Committee**.

At the 2017 Fall National Meeting, the Task Force continued its work on the Subgroup's Baseline Blanks Proposal and Note Blanks Proposal. The proposals expand the scope of the data that is collected as part of the Macro-Prudential Monitoring Initiative. Members of the Task Force noted that interested parties who usually follow these blanks proposals appeared not to be aware of these proposals. Therefore, the Task Force exposed the proposals for an additional 45-day period, with comments due by January 16, 2018. Members of the Task Force also noted that the information sought to be collected is already kept by insurers and would not present an additional burden.

The Task Force heard a report on the Subgroup's work to develop a liquidity stress-testing framework for large life insurers. The Subgroup received presentations from four life insurance companies regarding liquidity management. Themes that emerged from the presentations include the limited utility of performing stress testing at the group-wide level due to limitations on the transferability of assets, the timing of reviews, with material entities reviewed quarterly and additional entities reviewed annually, and the need for more tailored stress-test events.

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Please do not hesitate to contact us with any questions.

Please click here for a recording of the recent NAIC Fall National Meeting client briefing highlighting these topics.

NEW YORK

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