

## NAIC 2009 SUMMER NATIONAL MEETING

June 22, 2009

To Our Clients and Friends:

The National Association of Insurance Commissioners (the “NAIC”) held its 2009 Summer National Meeting (the “Summer Meeting”) from June 13 to 16, 2009, in Minneapolis, Minnesota. This Client Update highlights some of the developments from the Summer Meeting that are of particular interest to many of our insurance industry clients, including developments related to: (1) proposed capital and surplus relief for life insurers and certain life insurance policies and variable annuity contracts; (2) a reinsurance collateral guidance memorandum that will be sent to state insurance regulators; (3) revisions to the mortgage experience adjustment factor (“MEAF”) used in life insurer risk-based capital calculations; (4) potential revisions to the NAIC Insurance Holding Company System Regulatory Act (Model 440); (5) principles-based reserving for life insurers; and (6) a proposal to reduce capital charges to life insurers resulting from ratings downgrades of residential mortgage backed securities.

### CAPITAL AND SURPLUS RELIEF FOR LIFE INSURERS

As reported in previous client updates, in November 2008 the American Council of Life Insurers submitted a nine-part proposal to the NAIC (the “ACLI Proposal”), suggesting certain actions the NAIC could take to provide relief from conservative reserve and risk-based capital standards applicable to life insurers, life insurance policies and annuity contracts. The Capital and Surplus Relief (E) Working Group met during the 2009 Spring National Meeting and referred many aspects of the ACLI Proposal to the various technical working groups and task forces of the NAIC. During the Summer Meeting, many of these working groups and task forces presented recommendations regarding various aspects of the ACLI Proposal.

The Life and Health Actuarial Task Force (“LHATF”) recommended the following:

- adoption of new Actuarial Guideline 1C, providing that a recalculation of segments under Section 4B of the Valuation of Life Insurance Policies Model Regulation (Model 830) is not required for policies issued on a policy form filed for approval prior to January 1, 2010 that are subject to a company election to substitute the 2001 Preferred Class Structure Table for the 2001 CSO Mortality Table;
- revisions to the Valuation of Life Insurance Policies Model Regulation (Model 830) (“Regulation XXX”), removing certain artificial X factor restrictions from the deficiency reserve calculation;

- revisions to the Actuarial Opinion and Memorandum Regulation (Model 822), relating to disclosure in the regulatory asset adequacy issues summary; and
- revisions to the Model Regulation Permitting the Recognition of Preferred Mortality Tables for use in Determining Minimum Reserve Liabilities (Model 815), permitting use of the 2001 CSO Preferred Class Structure Table for the valuation of certain policies issued prior to January 1, 2007 with regulatory consent and provided certain conditions are met.

The first three of these recommendations were adopted by the Life Insurance and Annuities (A) Committee (the “A Committee”) and are expected to be implemented in the upcoming months. Since LHATF voted by only a narrow margin to make the fourth recommendation, the A Committee chose to allow regulators and interested parties additional time for further review and comment.

#### REINSURANCE COLLATERAL GUIDANCE

In addition, at the Summer Meeting, the Reinsurance (E) Task Force (the “Reinsurance Task Force”) approved the distribution of a collateral guidance memorandum discussing potentially acceptable forms of reinsurance collateral. This memorandum will be distributed to state insurance regulators to be used as non-binding guidance explaining the regulators’ preexisting authority under the Credit for Reinsurance Model Law (Model 785) and the Credit for Reinsurance Model Regulation (Model 786) to accept “any other form of security acceptable” to the regulator. Although the ACLI Proposal suggested that a model bulletin be distributed with the memorandum, the Reinsurance Task Force chose not to adopt the bulletin as there would be no changes to existing law.

#### MORTGAGE EXPERIENCE ADJUSTMENT FACTOR

One part of the ACLI Proposal suggested modifying the minimum and maximum values of the MEAF used in risk-based capital (“RBC”) calculations. The purpose of the MEAF is to help calculate the appropriate amount of capital an insurer should hold based on the composition of the insurer’s commercial mortgage portfolio, as commercial mortgages are not rated. The MEAF is calculated by dividing a measure of the insurer’s historical commercial mortgage default experience by an industry average of commercial mortgage defaults calculated over the previous eight quarters. Since commercial mortgage default rates have been very low until recently, the denominator in this equation is near zero. As a result, just one or two defaults in an insurer’s commercial mortgage loan portfolio could cause a significant increase in the insurer’s MEAF and therefore in its required RBC.

In response, the Capital Adequacy (E) Task Force (the “Capital Adequacy Task Force”) voted to increase the minimum MEAF from 50% to 75% and decrease the maximum

MEAF from 350% to 125%. These modifications will be effective only for RBC calculations as of December 31, 2009 and the Capital Adequacy Task Force, together with the American Council of Life Insurers, will continue to work on developing a permanent solution.

#### NAIC MODEL INSURANCE HOLDING COMPANY ACT

At the Summer Meeting, the Group Solvency Issues (EX) Working Group (the “Group Solvency Issues Working Group”) reviewed responses to questionnaires previously distributed to state insurance regulators and other interested parties regarding the consolidated supervision of insurance conglomerates and the NAIC Insurance Holding Company System Regulatory Act (Model 440) (the “Model Holding Company Act”). Among other things, the Model Holding Company Act provides for regulatory oversight of various activities that take place within insurance holding company systems, including acquisitions of control of an insurer, transactions between an insurer and another affiliate, and the payment of dividends by insurers. Every U.S. state has an act based on the Model Holding Company Act or that is similar to the Model Holding Company Act.

In light of the financial crisis, the questionnaire solicited feedback on the potential development of a scheme of consolidated group-wide supervision for insurance conglomerates and concomitant modifications of the Model Holding Company Act, including potential changes designed to improve regulatory oversight of insurers and promote cooperation among state, federal and international regulators.

State regulators submitted a wide array of responses to the questionnaire, some of which are summarized below:

- The Kansas insurance regulator suggested revising the Model Holding Company Act to provide (1) authority for state insurance regulators to undertake examinations of holding companies of an insurer, (2) authority to require holding companies of an insurer to maintain a specified minimum amount of capital, and (3) authority to review and subject to prior regulatory approval any transactions among affiliates of an insurer that may have a detrimental impact on an insurer, even if the insurer is not a party to the transactions. The Kansas regulator also suggested consideration of an asset protection law that would forbid encumbrances on assets supporting the reserves of regulated insurers. We believe that this asset protection law is the kind of law already enacted in North Carolina, Texas and Virginia.
- The Nebraska insurance regulator suggested amendments that would mandate or permit “supervisory colleges” of state insurance regulators to coordinate on the supervision of large multi-state insurance conglomerates, and that would mandate the filing of

insurance conglomerate registration statements with the NAIC. The Nebraska insurance regulator also suggested that the NAIC consider as a model for reform a recently enacted Nebraska insurance law that permits insurance conglomerates to elect to submit to supervision by the Nebraska regulator as a consolidated group.

- The South Carolina insurance regulator urged more stringent restrictions on cost sharing arrangements, noting its perception that many such arrangements are inappropriately structured to remove capital from insurers.
- The Virginia insurance regulator suggested revisions that would permit the examination of any affiliate of an insurer in order to determine the possible effects of its activities on the holding company system and the insurer.
- The Washington insurance regulator recommended revisions that would, among other things, (1) require registration of all holding companies with the states and the NAIC, (2) require holding companies to file financial data with regulators in a standard format, (3) require that holding companies provide state insurance regulators with copies of filings with any federal regulators and (4) expand the range of transactions and other activities within a holding company system that would require the prior approval of an insurer's domestic state insurance regulator.
- The Wisconsin insurance regulator noted its view that problems relating to holding company systems stem primarily from lack of disclosure rather than lack of statutory authority, and urged greater communication among different functional regulators within holding company systems. The Wisconsin regulator highlighted recent difficulties involving the securities lending activities of insurers, and urged action to improve the ability of regulators to identify and combat risks of the type that were not properly disclosed and addressed in the context of securities lending.
- The Missouri insurance regulator advocated changes that would heighten the evidentiary requirements needed to rebut a presumption under the Model Holding Company Act that any person holding 10% or more of the voting securities of an insurer exercises "control" over that insurer.

The Group Solvency Issues Working Group plans to hold an interim meeting prior to the NAIC's Fall National Meeting, to be held in Washington, D.C. from September 21-24, 2009 (the "Fall Meeting"). At the interim meeting, the Group Solvency Issues Working Group intends to decide which suggested changes to the Model Holding Company Act have broad support among state insurance regulators and members of the working group. Once this process is complete, the Group Solvency Issues Working Group will submit a proposal to

the E Committee and the Solvency Modernization Initiatives (EX) Task Force at the Fall Meeting in order to request that the Model Holding Company Act be considered for amendment. At this stage, it is not clear what types of amendment, if any, will be advanced by the Group Solvency Issues Working Group, nor is it clear whether recent federal proposals for comprehensive financial regulatory reform will affect the Group Solvency Issues Working Group's approach to the Model Holding Company Act. On June 17, 2009 President Obama announced his administration's proposals for federal financial regulatory reform. (See our Client Update, "Financial Regulatory Reform: Implications for the Insurance Industry," dated June 18, 2009, available at [www.debevoise.com](http://www.debevoise.com).)

#### PRINCIPLES-BASED RESERVING FOR LIFE INSURERS

At the Summer Meeting, the NAIC continued its work on a principles-based reserving approach for life insurers. LHATF adopted a final draft of the revised Standard Valuation Law ("SVL") designed to implement principles-based reserving, together with a recommendation that the revised SVL and the corresponding valuation manual be adopted by the NAIC plenary at the same time. Among other things, the revised SVL provides that:

- minimum reserving standards for policies issued on or after the operative date of the valuation manual shall be prescribed in the valuation manual;
- if a specific valuation requirement in the valuation manual is not, in the opinion of the commissioner, in compliance with the SVL, then companies shall, with respect to such requirements, comply with minimum valuation standards prescribed by regulation;
- the commissioner may engage a qualified actuary, at the expense of a company, to perform an actuarial examination of the company and opine on the appropriateness of any reserve assumption or method used by the company or on the company's compliance with any requirement of the SVL;
- the commissioner may require a company to change any assumption or method that in the opinion of the commissioner is necessary in order to comply with the valuation manual or the SVL; and
- a company using a principles-based valuation for one or more policies or contracts shall (1) establish procedures for corporate governance and oversight of the actuarial valuation function consistent with those described in the valuation manual, (2) provide to its board of directors and the commissioner an annual certification of the effectiveness of the internal controls with respect to the principles-based valuation; and (3) develop, and file with the commissioner upon request, a principles-based valuation report that complies with standards prescribed in the valuation manual.

Though the details of principles-based valuation requirements will be set forth in the valuation manual, the SVL provides that reserves established using a principles-based valuation must:

- quantify the benefits and guarantees, and the funding, associated with the contracts and their risks at a level of conservatism that reflects conditions that include unfavorable events that have a reasonable probability of occurring during the lifetime of the contracts;
- incorporate assumptions, risk analysis methods and financial models and management techniques that are consistent with, but not necessarily identical to, those utilized within the company's overall risk assessment process, while recognizing potential differences in financial reporting structures and any prescribed assumptions or methods;
- incorporate assumptions that are prescribed in the valuation manual or, for assumptions that are not prescribed, assumptions are established using the company's available experience, to the extent relevant and statistically credible, or to the extent that company data is not available, relevant, or statistically credible, are established utilizing other relevant, statistically credible experience; and
- provide margins for uncertainty including adverse deviation and estimation error, such that the greater the uncertainty the larger the margin and resulting reserve.

The SVL was exposed for a 30-day public comment period, after which the A Committee plans on holding a joint conference call with the Solvency Modernization Initiative (EX) Task Force and its Principles-Based Reserving Working Group (the "PBR Working Group") and to consider the SVL and any comments received.

The revised SVL is designed to allow states to follow the requirements of the valuation manual, as revised periodically by the NAIC, without having to adopt new legislation or regulation. The valuation manual, in turn, is intended as a reserving analogue to the NAIC's Accounting Practices and Procedures Manual and is meant to set forth details relating to the principles-based reserving framework. LHATF continued its work on the valuation manual during the Summer Meeting, considering and re-exposing for comment certain sections of the manual including VM-20: Requirements for Principles-based Reserves for Life Products ("VM-20"). In addition, LHATF considered narrowing the scope of VM-20, at least initially, to apply only to universal life insurance products with secondary guarantees and term insurance products instead of all life insurance products. Supporters of this proposal argued that narrowing of scope of VM-20 would facilitate completing VM-20 in a timely manner so that it could be adopted by the NAIC plenary concurrently with the SVL.

In addition, just prior to the Summer Meeting, the PBR Working Group exposed a revised draft of VM-G: Corporate Governance Guidance for Principles-Based Reserves (“VM-G”). Among other things, this revised draft provides that, consistent with an insurance company’s board of director’s general oversight responsibilities, the board is responsible for general oversight of the company’s principles-based reserves actuarial function. The board may fulfill this responsibility by reviewing reports of senior management and the appointed actuary. The comment deadline for VM-G is June 29, 2009 and the PBR Working Group has scheduled a conference call on July 8, 2009 to discuss comments received and finalize the draft.

#### RESIDENTIAL MORTGAGE-BACKED SECURITIES HELD BY LIFE INSURERS

Prior to the Summer Meeting, the NAIC received a proposal from the American Council of Life Insurers requesting that the Valuations of Securities (E) Task Force (the “Valuation of Securities Tack Force”) and the Capital Adequacy Task Force review the impact on life insurer RBC calculations of recent ratings downgrades of Residential Mortgage-Backed Securities (“RMBS”) by Nationally Recognized Statistical Rating Organizations (“NRSROs”).

More specifically, the American Council of Life Insurers noted that NRSRO RMBS rating models, while taking into account the likelihood of losses, often fail to account properly for the severity of losses. In other words, the NRSRO rating does not consistently distinguish among RMBS for which minor losses are expected and RMBS for which significant losses are expected. To address this perceived shortcoming, the American Council of Life Insurers suggested that the NAIC increase NAIC-assigned ratings for certain structurally senior RMBS to a level that exceeds the applicable NRSRO rating. This change would mitigate the adverse effects on life insurer RBC calculations of recent NRSRO ratings downgrades of RMBS.

At the Summer Meeting, the Capital Adequacy Task Force and the Valuation of Securities Tack Force reviewed the proposal, receiving comments from interested parties. The Valuation of Securities Task Force expects to continue consideration of the issues raised by the proposal over the coming months.

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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