

# CLIENT UPDATE

## NAIC 2013 FALL NATIONAL MEETING

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The National Association of Insurance Commissioners (NAIC) held its 2013 Fall National Meeting from December 15 to 18, 2013 in Washington, DC. 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:

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For purposes of this report:

- “ACLI” means the American Council of Life Insurers.
- “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.
- “FSOC” means the Financial Stability Oversight Committee.
- “G-SII” means a global systemically important insurer.
- “IAIG” means an internationally active insurance group.
- “IAIS” means the International Association of Insurance Supervisors.
- “SIFI” means a systemically important financial institution.
- “SVO” means the NAIC Securities Valuation Office.

On December 12, 2013, just days before the beginning of the Fall National Meeting, FIO issued its long-awaited report as required under the Dodd-Frank Act Section 502 (31 U.S.C. § 313(p)), entitled “How to Modernize and Improve the System of Insurance Regulation in the United States” (FIO Report).<sup>1</sup> The FIO Report recommendations will likely be the subject of NAIC discussions and actions in the future.

## **(1) REINSURANCE MATTERS**

### *Implementation of the 2011 Amendments to the Credit for Reinsurance Model Law and Regulation*

The **Reinsurance (E) Task Force** received a status report on state implementation of the 2011 amendments to the Credit for Reinsurance Model Law and Regulation which included the addition of reduced collateral for unauthorized reinsurers that are “certified reinsurers” that, in the case of non-U.S. reinsurers, are domiciled and licensed to transact insurance or reinsurance in a “qualified jurisdiction.” There has been no change since the summer 2013 report, in which it was reported that 18 states have enacted the 2011 amendments to the Model Law and Regulation, with the insurers domiciled in these 18 states writing approximately 53% of the primary insurance premiums in the U.S. Five additional states continue to consider enactment of the 2011 amendments to the Model Law and Regulation. The FIO Report recommends that the FIO pursue a “covered agreement” (as defined in the Dodd-Frank Act) with foreign regulators based on the

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<sup>1</sup> The FIO Report can be found at <http://www.treasury.gov/initiatives/fio/reports-and-notice/Pages/default.aspx>.

Model Act and Regulation which could have a meaningful impact on its further development and implementation.

### *NAIC Qualified Jurisdictions List*

The NAIC has developed a procedure to evaluate whether non-U.S. jurisdictions meet the standards of a “qualified jurisdiction” under the 2011 amendments to the Credit for Reinsurance Model Law and Regulation, and has a special working group that does this evaluative work. The **Qualified Jurisdiction (E) Working Group** reported on its summary of findings and recommendations related to the Expedited Review Procedure for the NAIC List of Qualified Jurisdictions. An expedited review of four jurisdictions, Bermuda, Germany, Switzerland, and the United Kingdom, was completed with a recommendation by the Working Group that each be listed as a conditional qualified jurisdiction for a period of one year effective January 1, 2014.

The Working Group plans to undertake the following tasks in 2014: (1) conduct a complete review of each of the listed jurisdictions; (2) engage other jurisdictions, including Ireland and France, in conversations to begin the process for gathering information and conducting a review determination of and qualification as qualified jurisdictions; and (3) incorporate recommendations from the FIO Report into the Credit for Reinsurance Model Law or Regulation standards to become a qualified jurisdiction.

### *U.S. Certified Reinsurers – NAIC Peer Review*

The **Reinsurance Financial Analysis (E) Working Group** has continued its role as a peer reviewer to individual states certifying unauthorized reinsurers for reinsurance collateral reduction purposes and has approved 21 of the 28 reinsurers certified by the New York, Florida, and Connecticut state insurance regulators. One reinsurer is currently under review by the Working Group, 6 of the 28 reinsurers have not been taken up by the Working Group (some because the reinsurer does not wish to qualify for passporting), and approval for the process applicable to one reinsurer could not be agreed upon. Pennsylvania is currently considering applications by two new reinsurers. The 21 approved reinsurers should be notified by the lead state insurance regulator of their approval by the NAIC. Upon approval, the reinsurers will be entitled to have the certification process undertaken by the lead state passported to other states for purposes of qualifying for collateral reduction.

In evaluating the certification process for each unauthorized reinsurer by the individual state insurance regulators, the Working Group encountered issues surrounding discrepancies associated with slow pay for collection on judgments. One of the

considerations the Working Group will undertake in 2014 is to determine a de minimis threshold standard below which they will not request reconciliation of discrepancies associated with this issue. Additional steps the Working Group will undertake in 2014 include: (1) consideration of new applications; (2) consideration of the development of a standard application form; (3) development of procedures to analyze financial conditions of reinsurers that, moving forward, will qualify for the passporting; and (4) renewal of qualification.

## **(2) CORPORATE GOVERNANCE**

### *IAIS Update*

Ryan Workman of the NAIC provided an update to the **Corporate Governance (E) Working Group** on the IAIS, which had conducted two meetings since the last Working Group meeting. Mr. Workman stated that the FSB paper regarding risk culture was now out for consultation. Further, Mr. Workman stated that the current task for the FSB was to finalize the draft of the “issues paper” project, which is to be an educational tool illustrating the various structures and governance options for insurance entities (it will be used merely as a tool and will include opinions on the quality of the options), so that the paper could be distributed for comment in early 2014.

### *Annual Financial Reporting Model Regulation*

The **Corporate Governance (E) Working Group** received three comment letters to the draft of the proposed revisions to the Annual Financial Reporting Model Regulation, which incorporates a new section for “Internal Audit Function Requirements.” The comment letters received were from The Institute of Internal Auditors, The Travelers Companies, Inc. and a joint letter from various interested parties. The two most contentious comments, which the Working Group rejected, were proposals by the interested parties (1) to exempt from the internal audit function requirements those entities that are compliant with the Sarbanes-Oxley Act of 2002, and (2) to include confidentiality provisions. The Working Group stated that there is no explicit requirement under the Sarbanes-Oxley Act of 2002 for the internal audit provided for in the proposed regulation. Furthermore, it rejected the need for confidentiality provisions on the basis that any such language could conflict with state confidentiality laws and regulations and was not necessary given the scope of the requirements, namely, that there was requirement that a filing be made with state insurance regulators. The Working Group further stated that the draft Model Regulation amendment merely codifies current market practices which have operated under the state confidentiality provisions for years, and thus inclusion of any

confidentiality language in the Model regulation amendment is unnecessary and would likely only cause problems through conflict.

Some other notable points of discussion were:

- The Working Group agreed to revise the definition of “internal audit function,” as requested by the Institute, to align the term with the globally recognized definition of internal auditing.
- The Working Group rejected the addition of a defined term for “assurance” that Travelers suggested. The Working Group noted that to alleviate Travelers’ concern as to the requirement of the level of assurance needed to be provided by the internal audit committee, it would revise the draft to clarify that reports by the internal audit committee would provide “reasonable assurance” and not absolute assurance.
- The Working Group agreed to further clarify that insurers not meeting the threshold size requirements for maintaining an internal audit function are “encouraged but not required” to conduct the prescribed internal audit functions. The Institute’s request to broaden the scope of the new “Internal Audit Function Requirements” was accepted by the Working Group and will be incorporated into the next draft.
- The Working Group also agreed that the audit committee should meet no less than annually (instead of quarterly as currently proposed), and that this change will be reflected in the next draft.

The Working Group decided that, rather than adopting the Model Regulation amendment now, they would further revise the Model Regulation amendment to reflect the discussion and recirculate it for another round of comments. The Working Group is hopeful that a final Model Regulation amendment can be adopted by the NAIC in the first quarter of 2014.

### *Corporate Governance Annual Filing Model Act and Guidance Manual*

The **Corporate Governance (E) Working Group** briefly discussed the draft of the Corporate Governance Annual Filing Model Act and the draft Guidance Manual. The Working Group Chair, Vermont Commissioner Susan Donegan, summarized the concerns expressed to date on the drafts, the most important of which was the opposition to the creation of the Guidance Manual and the incorporation of the Guidance Manual into the Model Act. Commissioner Donegan stated that the Guidance Manual is critical for state insurance regulators but agreed that the Working Group could take steps to limit the breadth of the Guidance Manual (i.e., provisions regarding procedures for changes, ban on addition for new sections). On behalf of the Trade Coalition, the Property Casualty

Insurers Association of America and the ACLI stated that the coalition opposed the inclusion of a guidance manual at all and would oppose exposing the current draft of the Model Act and Guidance Manual for comment, to which Pennsylvania Deputy Commissioner Steve Johnson retorted that exposure would force the trade groups to explicitly indicate their concerns, as he feels the current draft already includes provisions to alleviate any concerns. Others from the Trade Coalition, including Blue Cross, did state that they were in favor of exposing the Model Act and Guidance Manual to comment.

The Working Group decided to submit the draft of the Corporate Governance Annual Filing Model Act and the draft Guidance Manual for comment by interested parties, with the comment period to end on January 31, 2014.

### **(3) FINANCIAL STABILITY (EX) TASK FORCE**

The **Financial Stability (EX) Task Force** heard an update on the FSOC process. Companies designated by FSOC as nonbank SIFIs are subject to enhanced prudential standards. Missouri Director John Huff, the designated state insurance regulator serving on the FSOC, commented on the FSOC's bank-centric approach, pointing out that there is only one voting member on the FSOC with insurance expertise. Director Huff proposed that the other regulators on FSOC defer to those who have the relative industry experience when determining whether an institution is a nonbank SIFI. He also proposed that the FSOC specify activities that give rise to a SIFI designation. Director Huff expressed concern that there could be a greater risk for regulatory overreach and market disruption when actions are taken by those who do not have the proper expertise. He recommended that state insurance regulators monitor the nonbank SIFI designations and aim to educate the FSOC on the insurance industry.

The Task Force also heard remarks on nonbank designations from Roy Woodall, the independent member with insurance expertise on the FSOC. Mr. Woodall expressed concern over FSOC's emphasis on whether an insurance company is a "systemic threat" in its designation process. Mr. Woodall explained this analysis is misguided because it focuses on what would happen if an insurance company failed, which is an improbable and extreme result given regulatory intervention and other factors particular to the industry. He further emphasized Director Huff's earlier point on identifying risky or disfavored activities as a means of improving the FSOC designation process. Mr. Woodall noted that the Dodd Frank Act has a two-step designation standard which analyzes both risky activities as well as the impact of material distress, and could therefore serve as a model for improvement.

The Task Force also heard an update on IAIS Macro Prudential Policy and Surveillance from Ed Toy of the NAIC. The Task Force has published a macro-prudential paper, identifying a number of different macroeconomic risks that affect the insurance industry. The paper has been sent to the IAIS for comments.

#### **(4) REINSURANCE CAPTIVES**

##### *PBR and Reinsurance Captives*

The **Principles-Based Reserving Implementation (EX) Task Force** continued discussing the implementation of principles-based reserving legislation throughout the U.S.

One of the charges of the Task Force is developing possible solutions to address remaining XXX and AXXX perceived redundancies by changing the underlying reserve requirements rather than by using captive insurers. A discussion of captive insurers took up the entire meeting.

The Task Force met with Neil Rector of Rector & Associates Inc., who had been charged with preparing a report to assist the Task Force in making recommendations to the Executive (EX) Committee regarding principles-based reserving. Rhode Island Superintendent Joseph Torti stated that the purpose of meeting with Mr. Rector was to give his group instructions on next steps.

The initial report from Rector & Associates Inc., which was issued in September 2013, set forth potential issues and a framework for solving those problems. One of the conceptual underpinnings of the proposed framework was that insurers should be allowed to use lower quality assets to support the portion of reserves that correspond to a low probability that such assets would be needed to pay claims, and with high quality assets backing the reserves that would have a higher probability of crystallizing into claims. In order to implement that approach, and to provide consistency and a level playing field, the report states that insurers and regulators would need to use the same actuarial standard to determine what portion of the reserves would be allowed to be backed by lower quality assets.

Superintendent Torti stated that there were some key issues to be addressed in the initial report of Rector & Associates Inc., and which he sought to get feedback regarding at the meeting. One of the issues listed in the initial report was "Determine what constitutes the 'Actuarial Standard' and how it is to be used to determine the 'Primary Asset Requirement'."

Although the use of different asset classes to back reserves was not expressly set forth as the correct approach in the meeting, the Task Force did speak at length about developing an appropriate actuarial standard for XXX/AXXX business. A representative from the Iowa Insurance Division stated that it would place a moratorium on new XXX/AXXX reserve financing transactions if a standard that the Iowa Insurance Division viewed as appropriate were reached. The Task Force acknowledged that there was no uniform standard applied across all states to XXX/AXXX reserve financing transactions. A representative from the Virginia Bureau of Insurance stated that it felt that VM-20 (the part of the new NAIC Valuation Manual that includes the “Requirements for Principle-Based Reserves for Life Products”) should be that standard, but there was some disagreement whether using VM-20 would be appropriate.

Mr. Rector pointed out that while the ideal solution would be to come up with a reserving standard with wide acceptance, it is not completely necessary to do so in order to give him and his group further instructions. Mr. Rector proposed a dual path approach where his group could continue their work to develop the framework set forth in their initial report using VM 20 in its current form as the appropriate standard, while the Task Force and others at the NAIC could work to refine VM 20 in order for it to be more widely accepted. There was some agreement from the Task Force that this dual approach would be appropriate, but the Task Force did not give any clear instruction to Mr. Rector, nor was it clear what next steps the Task Force might take.

Other topics of interest were briefly discussed during the course of the discussion. Superintendent Torti stated that the Task Force is only looking at captive insurers used in XXX/AXXX financing transactions. He suggested considering the narrowing of Section 3.D of the Credit for Reinsurance Model Law, which permits a state’s insurance regulator to accept (in addition to cash, rated securities and unconditional letters of credit) “any other form of security acceptable to the commissioner” as collateral for the liabilities ceded by an insurer to a captive insurer.

Another question raised by Superintendent Torti was whether there should be a moratorium on XXX/AXXX financing transactions that involve captive insurers and special purpose vehicles. No consensus was reached on the point, but there did seem to be more support from the Task Force that there should be a moratorium once principles-based reserving legislation is implemented in the states.



### *Reinsurance Captives and NAIC Accreditation Standards*

At the meeting of the **Financial Regulation Standards and Accreditation (F) Committee**, Rhode Island Superintendent Joseph Torti presented in advance of the meeting a question to Missouri Director John Huff, the Committee Chair, as to whether captive insurers that reinsure business in other states, i.e., captive insurers that reinsure XXX/AXXX risk, should be subject to the NAIC accreditation program that requires states to hold insurers to certain standards, including certain capital standards. Currently, states do not hold such captive insurers to such standards.

This question arose from Superintendent Torti's review of the Interim Annual Review document that is part of the NAIC accreditation review program, which says "surplus lines companies and reinsurers licensed in one state but operating in more than one state are considered multi-state companies". The discussion at the Committee meeting revolved around whether this language should be read to mean that captive insurers that reinsure business, and thereby "operate" in more than one state, should be subject to the NAIC accreditation program standards.

The ACLI stated that just because captive insurers reinsure business originating in more than one state does not mean that they "operate" in multiple states. This interpretation was not accepted by Superintendent Torti.

Director Huff asked the NAIC staff liaison to clarify the history of the language, and it was clear that when the language was drafted, the number of captive insurers that acted as reinsurers was small enough that it was not considered.

Superintendent Torti asked that the Committee consider the NAIC accreditation standards to be evolving, and suggested that perhaps it was the intention of the Committee that the accreditation standards should have applied to captive insurers. Director Huff requested that the NAIC propose language for the Committee's review that would clarify the intention of the language.

### **(5) PRIVATE EQUITY OWNERSHIP OF INSURERS**

The **Private Equity Issues (E) Working Group** held its first public meeting, although there were two regulator-only conference calls prior to the meeting. The Working Group was formed pursuant to a directive from the Financial Analysis (E) Working Group. Working Group Chair, Virginia Deputy Commissioner Doug Stolte, stated that the Working Group would likely at least produce a best practices handbook and could potentially propose

regulatory policies. The Working Group decided to expose for comment the Financial Analysis (E) Working Group May 6, 2013 memorandum containing possible suggestions.

The Working Group heard a presentation from Apollo, a private equity fund, and Athene, its subsidiary, which own several U.S. life insurers and acquired two additional U.S. life insurers from Aviva in 2013. The presentation was an educational speech introducing Apollo and Athene to the Working Group, and focused heavily on Apollo's experience and success in the insurance space. The presentation described for the Working Group the rationales for private equity interest in the insurance market, what Apollo and Athene are, and concluded with a statement that Apollo does not oppose insurance regulation but requests any insurance regulation be implemented on a non-discriminatory basis.

Pennsylvania Deputy Commissioner Steve Johnson asked why people in the investment management space would want to move into insurance and how they become comfortable running insurers. The Apollo presenters stated that they undertake a very thorough diligence process for any acquisition, view management as partners in the process, and that, while Apollo is the shareholder and management runs the insurers, Apollo is very knowledgeable about insurance as the company and many of its principals have more than 20 years of experience in the insurance industry (including involvement in founding insurers). Working Group members also inquired how a private equity firm structures its agreements, how fees work, how it handles conflicts, and how it ensures arm's length negotiations. The Apollo presenters stated that prudence was the key, and suggested that Apollo's negotiations with Athene's management were some of the most difficult and that Athene cannot and has not ever invested in any of Apollo's portfolio companies. The Apollo presenters highlighted their success in the insurance space, noted that there are talents within the private equity space that can be leveraged for success in the insurance industry, but also noted that not all private equity firms are desirable purchasers, just as not all strategic companies are desirable purchasers.

## **(6) INTERNATIONAL INSURANCE MATTERS**

### *International Insurance Relations (G) Committee*

The **International Insurance Relations (G) Committee** heard updates on the activities of the IAIS. The FSB, which designated nine insurers as G-SIIs, is in the process of its annual review of the current list and the consideration of additional candidates for designation. The FSB's revised list of designated insurers is due in July 2014. The IAIS is working on developing multiple capital standards over the next few years, including (1) a backstop capital requirement to be finalized and ready for implementation by late 2014; (2) a Higher

Loss Absorbency capital standard to be finalized by the end of 2015 and implemented in 2019, both applicable to G-SIIs; and (3) a groupwide capital standard applicable to all IAIGs by 2016. The IAIS's work on the backstop capital requirement is to be released before the end of 2013 for a consultation period, and there will be a second consultation period in 2014.

The IAIS has formed a new working group for resolution planning for G-SIIs and IAIGs that will coordinate with the FSB and a newly-formed FSB working group. At the 2013 Summer National Meeting, the Committee approved a position paper on the Common Framework for the Supervision of Internally Active Insurance Groups (ComFrame), and at the Fall National Meeting discussed a draft position paper on international capital standards, which is intended to provide general guidance to regulators. The draft position paper cautions that "a single uniform capital standard is not the silver bullet solution" and emphasizes that the business model for insurance is significantly different than it is for banking, and that risk management approaches vary among insurers. The Committee also discussed NAIC draft comments on the IAIS 2013 ComFrame draft and passed a motion to submit the comments to the IAIS. Before the comments were submitted, additional language was added to suggest that as ComFrame moves forward, policies developed for G-SIIs and IAIGs should remain distinct since these are different categories of insurers that should not be treated the same way.

George Brady, Deputy Secretary General of the IAIS, also spoke to the Committee regarding the reorganization at the IAIS. The IAIS is working to reduce duplication of efforts, increase efficiency and reorganize the subcommittee structure and related procedures. The goal is to become more efficient but preserve discussions around setting standards, and to strike a balance between transparency and gains in efficiency. Interested parties expressed concerns about the process becoming less open and stressed that industry observers have an important role to play during the policy development, not just at the end when they are given the opportunity to comment. A representative from the Property Casualty Insurers Association of America said that the Association supports the goals of the IAIS, but believes strongly in the benefits of observer participation early. The Association representative urged the NAIC to strongly support this within the executive committee at the IAIS. Deputy Secretary General Brady also reported that the Reinsurance Subcommittee of the IAIS has been doing work relating to captives.

The Committee heard an update on the U.S./EU Dialogue Project and the "Way Forward" plan issued in December 2012, which contains initiatives to be pursued over the next five years. The Project's Steering Committee hosted a public event on December 14, 2013 to launch the initiatives set out in the plan. The plan includes seven technical areas, each

with its own committee staffed with experts from both jurisdictions. Nebraska Deputy Director and General Counsel Christine Neighbors gave an update on the committee for the third technical area (solvency and capital requirements). The committee's first step is to focus on capital requirements, and the second step is to bridge capital requirements and technical provisions for valuation. The focus towards the end of the five years will be on supervisory tools. As it moves into 2014 the committee will focus on operational risk, catastrophe risk and market risk (which includes currency risk, equity risk, real estate risk and concentration risk, among others). The Steering Committee has confirmed that the plan continues to be the basis for coordination with the EU.

The Committee then heard from Gabriel Bernardino, Chairman of the European Insurance and Occupational Pensions Authority. He provided an update on developments relating to Solvency II and his views on the role of the U.S./EU dialogue going forward. He pointed out that the U.S. and EU insurance markets are leaders and have a responsibility to create conditions for effective supervision and the protection of consumers. Acknowledging that Solvency II isn't perfect, he promoted the fact that it takes into account the evolution of the global business environment and the need for greater consistency by giving a clear mandate and powers to the group supervisor. He suggested that the IAIS is the right place to promote the consistency required by the evolution of the global business environment, and said the IAIS should present a capital standard that makes sense for insurance. He believes an international capital standard is inevitable and if the IAIS doesn't do it, then someone else will. He made clear that his suggestion is not that the global capital standard be equivalent to Solvency II, but contended that it should contain basic sound principles of risk-based regulation. He argued that, as state insurance regulators in the United States were able to build trust with risk-based capital, the same needs to happen worldwide. He repeated that the IAIS is the right organization to develop the global capital standard, but criticized the inefficiency and lack of effectiveness of the organization. He also criticized the governance of the IAIS and the fact that the voices of consumers are not strong enough in the IAIS. His view is that in Europe, insurance regulators are more aware of what the industry thinks what the IAIS thinks. He also emphasized the importance of consumer protection and market conduct, and said the NAIC/Authority dialogue has been very fruitful.

The Committee also heard an update on the North American Free Trade Agreement insurance dialogue. The primary goal of the dialogue is for the North American members of the IAIS to discuss mutual issues. On a recent conference call, participants discussed ComFrame, the reorganization of the IAIS and financial stability issues, and each jurisdiction provided updates. The group will reconvene during the first quarter of 2014.

*International Regulatory Cooperation (G) Working Group*

The **International Regulatory Cooperation (G) Working Group** received a status report from Hawaii Commissioner Gordon Ito on the International Fellows Program, which brings insurance regulators from foreign countries to the United States for an overview of the U.S. insurance regulatory system and introduces them to insurance departments in various states. So far, 198 fellows from over 90 countries have participated, and 30 U.S. jurisdictions have been hosts. Commissioner Ito encouraged other states to participate and emphasized the importance of the program. Missouri Consumer Affairs Director Matt Barton spoke about his state's positive experience when participating in the program. The Working Group also heard an update on international training programs, including seminars for the Association of Latin American Insurance Supervisors, the Central Bank of Curacao and Saint Maarten, the Russian Federal Financial Markets Service, the Thai Office of the Insurance Commission and the China Insurance Regulatory Commission.

The Working Group heard updates on the IAIS and its activities. The Supervisory Cooperation Subcommittee of the IAIS met in October 2013 in Taipei, where there was significant discussion about supervisory colleges. There has been significant progress on an IAIS paper relating to the structure of communication and the practical/operational challenges of supervisory colleges.

The Working Group also heard from George Brady, Deputy Secretary General of the IAIS, who thanked the NAIC for the work it does for the IAIS in terms of implementation. He briefed the Working Group on a new coordination implementation framework adopted by the IAIS in October 2013. The Basel Committee on Banking Supervision has taken the initiative with respect to testing the extent to which standards are being implemented around the world, and the IAIS has been receiving external pressure from the Basel Committee and others to move from a focus on heavy standard-setting to implementation. The goal is to ensure that the standards being set internationally are taking hold in jurisdictions around the world.

The new coordination implementation framework at the IAIS focuses its activities in a few areas, including regional engagement, cooperation with partners, a focus on the unique offerings of the IAIS and the proper alignment of all the work. The IAIS has been engaging with regions all over the world, including Africa and the Middle East. The IAIS is trying to find ways to better assist regions with implementation and supervision, while recognizing that it cannot function alone and has to rely on its partners. The Financial Stability Institute is a key sister organization to the IAIS and is exclusively focused on delivering seminars on insurance and banking. The IAIS will also work closely with the

World Bank. Deputy Secretary General Brady emphasized that the IAIS is an international community made up of supervisors from 190 jurisdictions and this breadth should be taken advantage of, while keeping in mind the need to design effective assistance.

### *International Solvency and Accounting Standards (E) Working Group*

The **International Solvency and Accounting Standards (E) Working Group** heard a presentation on the October 16, 2013 draft of the IAIS ComFrame. ComFrame is a set of international supervisory requirements focusing on the effective group-wide supervision of IAIGs. ComFrame is primarily intended to be a framework for supervisors to effectively cooperate and coordinate by providing a basis for comparability of IAIG regulation and supervisory processes. The Working Group discussed changes to Element 5 of Module 2 of ComFrame, which describes the process an IAIG will follow to assess its capital adequacy. The IAIS is in the process of developing a backstop capital requirement (which will be renamed a basic capital requirement) for IAIGs. It is not currently clear how the capital requirement will be calculated. There will be an extensive five-year field testing period conducted by volunteer insurers. Module 2 will be out for exposure at the end of March 2014. The IAIS has agreed to come to an agreement on a basic capital requirement by late summer of 2014.

The Working Group also discussed comments on the International Accounting Standards Board Conceptual Framework Discussion Paper. The IAIS submitted a comment letter on the discussion paper, noting that the paper was not sufficiently clear with respect to the status, meaning and intent of the Conceptual Framework. The letter will be submitted to the Board in early 2014.

## **(7) RISK-BASED CAPITAL DEVELOPMENTS**

### *Operational Risk Charge*

After considerable discussion, the **Capital Adequacy (E) Task Force** exposed the Operational Risk RBC Proposal, which is a factor-based operational risk approach for the life, health and property/casualty risk-based capital formulas, and voted to expose it for a 45-day comment period ending January 30, 2014. All comments should be directed to the Solvency Modernization Initiative RBC (E) Subgroup.

Once the methodology has been finalized, the Task Force intends to draft and submit for comment Operational Risk Charge Factors; it hopes to adopt these factors by mid-2014. Task Force members voiced concern at the pace of the development of the Operational Risk Charge methodology and factors, and opined that international considerations were

pushing the Task Force timeline. These members stated that the Task Force should take all reasonable time to develop and discuss the issues throughout 2014 and aim for implementation of final determinations in 2015, and stated that the Task Force should focus on understanding the intersection between Operational Risk Charge determinations pursuant to external methodologies and factors and entities' own internal risk philosophy and solvency assessments. Other Task Force members noted the apparent urgency was informed by international advancements, but also attempted to alleviate concerns by stating that the suggested timeline was not a firm commitment to finalize methodology and factors and that they merely want to be able to establish progress.

### *RBC Working Group Focus*

The **Capital Adequacy (E) Task Force** briefly reviewed a memo from the Connecticut Department of Insurance regarding the historical changes to minimum risk-based capital requirements, in which the Department raises several concerns and questions as to the approach of the various Working Groups on risk-based capital assessment. The memo asserts that resources dedicated to risk-based capital analysis are stretched thin and proposes a realignment of priorities – with RBC Working Groups and Subgroups initially focused on identifying problems or shortcomings related to either inappropriate regulatory consequences placed on the insurance industry, or insufficient regulatory ability to protect policyholders.

### *Title Insurance Risk-Based Capital*

The **Capital Adequacy (E) Task Force** received an update on the **Title Insurance Risk-Based Capital (C/E) Subgroup**, which ascertained that developing risk-based capital requirements for title insurers is not feasible at this time. The Subgroup also requested that the Financial Analysis Research and Development (E) Working Group consider the development of Insurance Regulatory Information System ratios and Financial Analysis Solvency Tools scores to title insurers. The Subgroup will disband at the end of 2013.

## **(8) LIFE INSURERS – CONTINGENT DEFERRED ANNUITIES**

The **Contingent Deferred Annuity (A) Working Group** reviewed its 2014 charges from the Life Insurance and Annuities (A) Committee. The Life Insurance and Annuities (A) Committee had requested that the Working Group (1) develop NAIC guidelines that will serve as a reference for states interested in modifying their annuity laws to clarify their applicability to contingent deferred annuities; (2) review existing NAIC model laws and regulations applicable to consumer protection issues with contingent deferred annuities; and (3) serve as the coordinating body with all of the NAIC technical groups with projects



related to contingent deferred annuities. The Working Group discussed the timeline for completion of these new charges and decided to gather additional information at the NAIC 2014 Spring and Summer National Meetings and aim to adopt revised guidelines at the NAIC 2014 Fall National Meeting. The Wisconsin regulators agreed to begin the initial draft of the revised NAIC guidelines.

## **(9) INSURER INSOLVENCY MATTERS**

### *Collection of Reinsurance Recoverables by Receivers of Failed Ceding Insurers*

The **Receivership Reinsurance Recoverables (E) Working Group** was formed in 2010 to address concerns about the timing and collection of reinsurance recoverables held by insurers in receivership. Based on surveys of the states and other work it had done, the Working Group recommended charging interest as a way to increase the likelihood of payout by reinsurers. Rather than amending any existing NAIC model act, the Working Group decided to draft a Model Guideline for use by states seeking to permit a receiver of a failed ceding insurer to collect the payment of interest on overdue reinsurance recoverables. During the Fall National Meeting, the Working Group discussed a draft of the Model Guideline, the “Model Guidelines For Payment of Interest to Receiver on Overdue Reinsurance Recoverables,” and interested parties suggested improvements including specifying that a “valid claim” is one that has been allowed by the receiver. The Model Guideline provides for accrual of interest (whether or not interest is provided under the reinsurance contract) if the reinsurer fails to pay a billed amount within 90 days after the billing date. All or a portion of the interest may be waived as part of an arbitration proceeding or by a receivership court. In addition, if requested by the reinsurer, a hearing must be held to determine whether a claim is a “valid claim.” The Working Group voted to expose the Model Guideline for a 60-day public comment period. Comments are due by February 14, 2014.

### *Life Guaranty Fund Coverage for Factored Structured Settlements and Life Settlements*

The **Receivership and Insolvency (E) Task Force** heard presentations on guaranty fund coverage for factored structured settlements and life settlements from the National Structured Settlement Trade Association, the Life Insurance Settlement Association, the National Organization of Life and Health Guaranty Associations and the ACLI. The National Structured Settlement Trade Association took the position that unfactored benefits should receive guaranty fund coverage but factored benefits should not, except in the case where it is difficult to tell factored from unfactored, or if withholding factored benefits would risk the non-payment of unfactored benefits. The Life Insurance Settlement



Association took the position that at least for life settlements, factored benefits should receive guaranty fund coverage, and argued against trying to build a distinction between types of owners in the same risk pool. The National Organization of Life and Health Guaranty Associations took the position that factored benefits should not receive guaranty fund coverage because a factoring company is an assignee of the payee and not within the scope of persons covered under the NAIC Life and Health Insurance Guaranty Association Model Act. The ACLI did not take a position on whether third-party investors should be covered.

## **(10) VALUATION OF SECURITIES**

### *Structured Agency Credit Risk Transactions*

At the 2013 Summer National Meeting, the **Valuation of Securities (E) Task Force** referred to the Invested Asset (E) Working Group the charge of studying the accounting and reporting classification for Freddie Mac's new residential mortgage-backed security (RMBS) and the Structured Agency Credit Risk (STACR), as well as reviewing the regulatory reporting framework for structured notes. At the Fall National Meeting, the Task Force adopted the recommendations of the Working Group that insurers file STACR transactions with the Structured Securities Group of the NAIC Securities Valuation Office, that the Group generate an NAIC designation using financial modeling, and that the security to be accounted for pursuant to SSAP No. 26 – Bonds, Excluding Loan-Backed and Structured Securities. The Task Force adopted definitions for "mortgage-referenced security" and "structured note."

### *Working Capital Finance Investments*

Following on the Statutory Accounting Principles (E) Working Group's adoption at the Fall National Meeting of SSAP No. 105 – Working Capital Finance Investments, which allows working capital finance investments to be admitted assets if certain criteria are met, the Task Force adopted an amendment to the SVO Purposes and Procedures Manual. The amendment has an effective date of January 1, 2014, which is also the effective date of SSAP No. 105, and provides that working capital finance investments are to be filed as Regulatory Treatment Analysis Service (RTAS) submissions.

### *SVO Manual Changes – No Reclassification of Securities*

Prior to the Fall National Meeting, the Task Force had directed the SVO to review the SVO Purposes and Procedures Manual to see what instructions needed amending based on a new classification methodology whereby as of January 1, 2013 the SVO no longer

reclassifies securities. At the Fall National Meeting, the Task Force received a report on reclassification from the SVO identifying four instructions in the SVO Purposes and Procedures Manual that require it to reclassify a security, as well as proposing changes. The Task Force instructed the SVO to propose an alternative procedure for principal protected notes and for catastrophe-linked bonds, to delete the instruction for short-dated non-principal protected instruments, and to delete two textual references to the pre-2013 reclassification instruction.

## **(11) OTHER MATTERS**

### *Revisions to Mortgage Guaranty Insurance Model Act*

The **Mortgage Guaranty Insurance (E) Working Group** discussed proposed modifications to the Mortgage Guaranty Insurance Model Act. The Working Group noted that there have been extensive revisions to the Model Act, which was first adopted by the NAIC in 1976. The Working Group proposes increasing the minimum capital and surplus to be held by a mortgage guaranty insurer. Under the proposed revisions, a mortgage guaranty insurer would not be permitted to conduct business unless it has paid-in capital of at least \$10 million and paid-in surplus of at least \$15 million (if a stock insurer), compared to a prior requirement of \$1 million for each of paid-in capital and paid-in surplus. The proposed revisions to the Model Act creates a two-tier capital structure: (1) Tier 1 Risk Based Capital RBC Model Requirements, similar to property/casualty insurers; and (2) Tier 2 Loan Level Capital Model Requirements, which set forth requirements upon the insurer's risk-based capital score falling below the company action level. The revised Model Act would also require mortgage guaranty insurers to contribute additional quarterly contingency reserves upon the occurrence of certain macroeconomic indicators of potential cyclical mortgage industry downturns.

The revised Model Act would also impose a number of state concentration limits on a mortgage guaranty insurer's business writings, including limiting direct business to no more than 10% of the total premiums written in one state. The reinsurance provision of the Model Act would also undergo extensive revisions. The Working Group proposes requiring a mortgage insurer to retain at least 25% of the policy risk in any reinsurance transaction, unless specifically approved by the state insurance regulator. The proposed revisions further restrict reinsurance transactions by prohibiting reinsurance arrangements with affiliates after the adoption of the Model Act and prohibit a mortgage guaranty insurer from entering into a captive reinsurance arrangement.

The exposure period for the Model Act revisions has been extended to February 15, 2014.

Interestingly, the FIO Report commented on regulation of mortgage guaranty insurers and recommended that federal standards and oversight of mortgage guaranty insurers should be developed and implemented.

### *Reauthorization of the Terrorism Risk Insurance Act of 2002*

The **Terrorism Insurance Implementation Working Group** discussed the potential reauthorization of the Terrorism Risk Insurance Act of 2002. The terrorism risk program expires at the end of 2014, and the NAIC has passed a resolution supporting the reauthorization of the Act to help ensure market stability. An NAIC representative reported that there are three bills to reauthorize the Act in the House, but none in the Senate yet.

## **(12) NAIC CORPORATE GOVERNANCE**

In a letter dated December 11, 2013 addressed to all state insurance regulators, Connecticut Commissioner Thomas B. Leonardi criticized the NAIC's corporate governance and recommended that the NAIC hire outside consultants to conduct a thorough evaluation of the NAIC's corporate structure. The NAIC is a Delaware non-profit corporation. At the **Executive (EX) Committee** meeting, Connecticut Commissioner Leonardi made a motion to empower the Committee's ad hoc corporate governance panel to hire an outside consulting firm to examine NAIC governance and provide recommendations for change. This motion was met with severe opposition by Indiana Commissioner Stephen W. Robertson, who proposed that the panel instead be tasked with assessing NAIC governance and reporting back on its own proposals before the Committee considers granting the panel the authority to hire outside consultants. This topic received lengthy attention. Several Committee members supported Commissioner Robertson and asserted that hiring outside consultants could be an embarrassment to the NAIC, with Pennsylvania Commissioner Michael F. Consedine reiterating that the ad hoc panel should examine the NAIC governance and report back on any concerns and suggestions prior to seeking outside consultants. New York Superintendent Benjamin Lawskey backed Commissioner Leonardi's motion, noting that New York consults with outside firms. Commissioner Leonardi stated he has raised several deeply disturbing corporate governance issues over the last few years to no avail and is concerned that continued internal assessment would be fruitless and merely stall necessary changes. Commissioner Leonardi's motion to empower the ad hoc governance committee to seek outside counsel was denied, but Commissioner Robertson's motion to task the ad hoc governance committee with evaluating governance issues and to report back to the Committee, passed.

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Please do not hesitate to contact us with any questions.

December 23, 2013