

Client update

NAIC 2014 Fall National Meeting

NEW YORK

Eric R. Dinallo
edinaldo@debevoise.com

Ethan T. James
etjames@debevoise.com

Thomas M. Kelly
tmkelly@debevoise.com

Marilyn A. Lion
malion@debevoise.com

Nicholas F. Potter
nfpotter@debevoise.com

Alexander R. Cochran
arcochran@debevoise.com

John Dembeck
jdembeck@debevoise.com

Risa Gordon
rgordon@debevoise.com

Sarah T. Kelly
stkelly@debevoise.com

Spencer K. Gilbert
skgilber@debevoise.com

Chen Xu
cxu@debevoise.com

The National Association of Insurance Commissioners (NAIC) held its 2014 Fall National Meeting from November 16-19, 2014 in Washington, D.C. 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.
- “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.
- “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.
- “RBC” means NAIC risk-based capital.
- “SEC” means the U.S. Securities and Exchange Commission.
- “SIFI” means a systemically important financial institution.
- “SVO” means the NAIC Securities Valuation Office.

(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 Credit for Reinsurance Model Regulation. Twenty-three states have enacted the Model Law amendments, representing 60 percent of direct insurance premiums. An additional five states are considering enacting the Model Law amendments, which would increase coverage to 80 percent of direct insurance premiums.

NAIC Qualified Jurisdictions List

The Task Force adopted the Qualified Jurisdiction (E) Working Group report, approving five foreign jurisdictions as qualified jurisdictions: Bermuda Monetary Authority, France: Autorité de Contrôle Prudentiel et de Résolution (ACPR), Germany: Federal Financial Supervisory Authority (BaFin), Central Bank of Ireland and United Kingdom: Prudential Regulation Authority of the Bank of England (PRA). In addition, reviews related to Switzerland: Financial Market Supervisory Authority (FINMA) and the Japan Financial Services Agency (JFSA) are expected to be completed by the end of 2014. The Executive (EX) Committee/Plenary is expected to approve all of these seven jurisdictions by the end of 2014, and status as qualified jurisdictions will be effective as of January 1, 2015. Once approved, a qualified jurisdiction is subject to re-evaluation every five years unless there is a material change in circumstances. Non-U.S. reinsurers must be domiciled in a qualified jurisdiction in order to become certified reinsurers and eligible for reduced collateral under the 2011 amendments to the Credit for Reinsurance Model Law and Credit for Reinsurance Model Regulation.

U.S. Certified Reinsurers – NAIC Peer Review (Passporting)

The Task Force discussed the Uniform Application Checklist for Certified Reinsurers. Interested parties stated that there has been a plateau in the number of states adopting certified reinsurer legislation. Interested parties also observed that it is not clear that, of all the 2011 amendments to the Credit for Reinsurance Model Law and Credit for Reinsurance Model Regulation, only the certified reinsurer amendments are optional for a state to remain NAIC accredited.

(2) CORPORATE GOVERNANCE

Annual Financial Reporting Model Regulation

During the 2014 Summer National Meeting, the Executive (EX) Committee and Plenary adopted revisions to the Annual Financial Reporting Model Regulation to incorporate an internal audit function requirement for large insurers. In an effort to supplement these revisions, the **Corporate Governance (E) Working Group** adopted and referred to the Financial Regulations Standards and Accreditation (F) Committee a memorandum that recommended Part A Accreditation Standards implement the internal audit function revisions.

Corporate Governance Annual Financial Reporting Model Act and the Corporate Governance Annual Disclosure Model Regulation

During the 2014 Summer National Meeting, the Executive (EX) Committee and Plenary adopted the Corporate Governance Annual Disclosure Model Act and the Corporate Governance Annual Disclosure Model Regulation. In an effort to supplement these revisions, the **Corporate Governance (E) Working Group** adopted and referred to the Financial Regulations Standards and Accreditation (F) Committee a memorandum that recommended Part A Accreditation Standards include a requirement for insurers to provide confidential annual disclosure of their corporate governance practices substantially similar to these recently adopted models. The debate around the memorandum focused on the language that provided for the confidentiality of the disclosures. On the one hand, industry commenters expressed concerns about the possible chilling effect on disclosure if the implementation of the confidentiality standards was compromised or weakened by some states during their adoption and proposed that implementing state legislation be “functionally equivalent” to the Model Act. On the other hand, a Florida regulator expressed a concern that the confidentiality provisions were overly broad, and potentially unenforceable. The Working Group adopted the memorandum as exposed.

(3) GROUP-WIDE SUPERVISION

Group-Wide Supervision

The **Group Solvency Issues (E) Working Group** continued its work drafting amendments to the Insurance Holding Company System Regulatory Act to provide for group-wide supervision of insurance groups, but deferred adoption of the amendments until a conference call that will be scheduled before December 31, 2014. After the 2014 Summer National Meeting, the Working Group held several conference calls, issued exposure drafts and accepted comments about the amendments. The ComFrame’s definition of IAIGs provides the definition of affected insurance groups under the amendments to the Model Act. In addition, if the insurance group does not meet the IAIG criteria, the amendments allow a state insurance regulator to become the group-wide supervisor or acknowledge another group-wide supervisor if the insurance group so requests or if “the commissioner finds that the insurance holding company system will likely qualify as an [IAIG] in the near future or that the presence of two ... criteria ... outweighs the absence of the other criterion”

At the Working Group meeting, discussion focused on: (1) the criteria for choosing a group-wide supervisor, (2) a state insurance regulator's discretion to apply group-wide supervision to non-IAIGs, and (3) the necessity of the catch-all provision that permits the group-wide supervisor to "conduct other group-wide supervision activities as considered appropriate by the commissioner."

Criteria for Selecting Group-Wide Supervisor

Interested parties generally were in agreement that recognition of a single group-wide supervisor was a positive development. However, there was disagreement about the factors that should be used to designate a group-wide supervisor. The Model Act amendments set forth a tiered multi-factor test for determining the group-wide supervisor, including the place of domicile of the insurer that holds the largest share of the insurance group's premiums, assets or liabilities. Several interested parties suggested adopting the NAIC lead state criteria because of industry and regulator familiarity, while others supported the tiered multi-factor approach with an emphasis on financial strength.

Commissioner Discretion in Applying Supervision

Interested parties cautioned against including a concept in the Model Act amendments that has not been adopted by the IAIS, namely a provision permitting a state insurance regulator to exercise discretion in designating insurers for group supervision. The Working Group referred this issue to the ComFrame Development and Analysis (G) Working Group, which agreed to consider the issue.

Catch-All Provision

Interested parties expressed concern about the broad scope of the catch-all provision. They suggested, for example, limiting the supervisor's powers to assess holding company activities that pose enterprise risk. Working Group members seemed inclined to leave the provision in the Model Act and emphasized industry's need to trust that state insurance regulators do not intend to break from existing practice to seize control of holding companies. Working Group members reiterated that adopting these amendments will send an important signal to the international community about the strength of U.S. supervisory authority.

The Working Group expects to hold a conference call to finalize and approve the amendments, meeting its December 31, 2014 deadline.

(4) RECEIVERSHIP AND INSOLVENCY

Coverage Limits in Guaranty Association Model Acts

The **Receivership Model Law (E) Working Group** received a report about the survey of the coverage limit provisions in state laws based on the Life and Health Insurance Guaranty Association Model Act and the Post-Assessment Property and Liability Insurance Guaranty Association Model Act. The survey concluded that the coverage limit provisions are substantially similar among the states with a few exceptions. The Working Group recommended to the Receivership and Insolvency (E) Task Force that as state laws do not present a uniformity problem, no further action is needed.

Receivership Model Laws and Guidelines

The Working Group began the process of studying receivership laws by asking interested parties and receivership experts to identify concepts key to ensuring efficient multi-state receiverships. Working Group members emphasized that the focus of the project would be on concepts rather than precise adherence to the Insurer Receivership Model Act. Interested parties expressed reluctance to discuss some of the more controversial aspects of the Model Act. Working Group members also suggested that the outcome of the project would provide guidelines for states but would not be tied to accreditation standards. Further discussions on this topic are expected to continue in 2015.

Qualified Financial Contracts

The **Receivership and Insolvency (E) Task Force** adopted the report of the Federal Home Loan Bank Legislation (E) Subgroup, which adopted guidance on qualified financial contracts (“QFCs”) for the Receiver’s Handbook for Insurance Company Insolvencies. The guidance references the Insurer Receivership Model Act QFC safe harbor and netting provisions, describes issues that receivers may encounter when resolving QFCs and presents recommended procedures.

(5) INTERNATIONAL INSURANCE RELATIONS

Regulatory Cooperation

The **International Regulatory Cooperation (G) Working Group** received a report on recent NAIC activities that have fostered international cooperation, including the International Fellows Program, the Asia Pacific Financial Forum and seminars for the Association of Latin American Insurance Supervisors and the China Insurance Regulatory Commission. The Working Group also reported on the IAIS’ Implementation Committee. NAIC staff stated that the IAIS has begun focusing on implementation of its supervisory standards. This focus extends to outreach programs, particularly in emerging markets, and partnership with other key institutions, such as the International Monetary Fund and the World Bank.

The **International Insurance Relations (G) Committee** heard a report on the U.S./EU Insurance Dialogue Project, which continues to focus on group supervision and insurance collateral. Pennsylvania became the sixth U.S. state and forty-third signatory to the IAIS Multi-lateral Memorandum of Understanding, a cross-border cooperation and information exchange agreement, when Pennsylvania Commissioner Michael Consedine signed the memorandum during the meeting.

ComFrame Field Testing

The **ComFrame Development and Analysis (G) Working Group** received a report on the IAIS ComFrame field testing process. The process has focused on quantitative testing of the Basic Capital Requirement, which will continue through 2015, but it is shifting to focus on qualitative field testing, which launched in October 2014. The qualitative field testing is of Module 2, which concerns group structure, corporate governance and enterprise risk management.

IAIS Capital Developments

The **ComFrame Development and Analysis (G) Working Group** received a report on IAIS capital developments, including the IAIS' adoption of the Basic Capital Requirement ("BCR"). Working Group members observed that the IAIS will refine the BCR over the next several years. Topics under consideration may include the scalar used to adjust the overall BCR level and the capital resources identified as core capital. Working Group members also observed that many elements that will be part of the capital requirements have been shifted to the global insurance capital standard ("ICS"). After the ICS is developed, it will replace the BCR as the foundation for the higher loss absorbency ("HLA") requirements. Working Group members expect that the ICS will have a higher calibration than the BCR currently has. An initial consultation document for the ICS will be released in December 2014 with data collection spanning late 2015 through early 2016. The IAIS also plans to release a second consultative draft.

Working Group members also expanded on the HLA's methodology, stating that it will be tied to drivers of systemic risk, which will be bucketed. The HLA's initial consultation document is expected to be released in mid-2015, a delay from the previously announced December 2014 release. Working Group members acknowledged that some have expressed concern that there will be only one opportunity to comment on the HLA, but stated that the IAIS is committed to delivering the HLA to the G20 by the end of 2015.

IAIS Transparency and U.S. Coordination

The **International Insurance Relations (G) Committee** heard a report on IAIS membership and process reforms, including the transition from observer status. A member of the IAIS Secretariat explained that stakeholders will still have a place in the development of IAIS standards. The IAIS will hold conference calls about drafts and solicit comments, hold open in-person meetings and global seminars, and publish comments. Meetings in the U.S. are tentatively scheduled for February and May 2015.

U.S. Group Capital

The **ComFrame Development and Analysis (G) Working Group** received a discussion document about an NAIC Group Capital Conceptual Framework, which is a proposed consolidated group-wide standard at the insurance group level that provides for a risk-based measure of capital adequacy. The document and discussion outlined three potential capital methodologies: (1) RBC Plus, (2) Cash Flow, and (3) Hybrid RBC Plus/Cash Flow.

RBC Plus would be similar to the existing legal entity RBC framework, using a consolidated U.S. GAAP approach plus adjustments and additions to account for risks not reflected in RBC. The advantages for this methodology include its familiarity for state insurance regulators and its reliance on audited financials. Disadvantages include the time and cost required to calibrate new factors, difficulty in accounting for diversification and difficulty meeting the IAIS' ICS principle on comparability.

A cash flow methodology would be similar to life insurer asset adequacy testing whereby cash flow in and out would be projected forward on an annual basis over the life of the policy portfolio under various stress scenarios. Advantages include accounting system and segmentation independence. Disadvantages include difficulty defining and calibrating stresses, and some difficulty for property/casualty insurers in implementing the framework.

The Working Group will accept comments on the draft Framework through December 5, 2014.

Joint Forum

The **International Insurance Relations (G) Committee** heard an update on the Joint Forum, which will begin winding down. Several Committee members and the IAIS representative stated that eliminating the Joint Forum was a step in the wrong direction because it eliminates a regular multilateral meeting that was used to discuss cross-sector risk issues.

(6) FINANCIAL STABILITY (EX) TASK FORCE

The **Financial Stability (EX) Task Force** heard an update that the FSB endorsed Basic Capital Requirements (BCR) for G-SIIs, which the IAIS adopted on October 23, 2014. BCR will serve as a foundation for Higher Loss Absorbency (HLA) requirements, which the IAIS will deliver next year. A consultation paper on HLA is expected in the second quarter of 2015. An on-going project at the FSB is minimum capital for G-SIIs to ensure that these companies have loss absorbency and that, in the case of resolution, critical functions can continue without threatening stability. The FSB and IAIS are currently exploring whether Total Loss Absorbency Capacity (TLAC) is appropriate for G-SIIs. The FSB released a consultation paper on critical functions for systemically important insurers, and comments are due December 15, 2014.

The Task Force heard an update on the FSOC from North Dakota Commissioner Adam Hamm, who was recently appointed to the FSOC and joined in September 2014. Commissioner Hamm reiterated that there is a lot going on at the FSOC, most of which he is not permitted to discuss publicly. He did emphasize the importance of annual reviews and transparency. On the annual reviews, he said that if the goal is to reduce the impact of “too big to fail,” then companies need to be told during the annual review of their SIFI status what steps they can take to shed the designation. He also expressed that there are deep concerns about transparency and that there is more that can be done there, especially with respect to the SIFI designations.

(7) REINSURANCE CAPTIVES

Actuarial Guideline 48

The **Principle-Based Reserving Implementation (EX) Task Force** adopted “Actuarial Guideline XLVIII—Actuarial Opinion and Memorandum Requirements for the Reinsurance of Policies Required to be Valued under Sections 6 and 7 of the NAIC Valuation of Life Insurance Policies Model Regulation (Model 830)” (“AG 48”), with only technical modifications to the

revisions thereto discussed by the Task Force on November 7, 2014. AG 48 sets forth standards that must be satisfied for an insurer ceding XXX and AXXX risks to certain reinsurers, including captive reinsurers, in order for the appointed actuaries of the ceding insurer and its affiliates to render an unqualified actuarial opinion under the Actuarial Opinion and Memorandum Regulation. AG 48 is the cornerstone NAIC action resulting from the February 2014 Rector Report and June 2014 Rector Modified Recommendations relating to XXX and AXXX reinsurance transactions. AG 48 is expected to be adopted by the Executive/Plenary Committees of the NAIC ahead of 2015, such that AG 48 will be effective on January 1, 2015. The Task Force debated the implications and merits of AG 48's adoption, with the New York member forcefully expressing his opposition to the measure. A number of the Task Force members indicated that they expected that, once VM-20 becomes fully effective, the use of new XXX and AXXX captive reinsurers would cease and that if such captives continued to be employed after the full effectiveness of VM-20, the Task Force would expect to take action in this regard.

Life Risk-Based Capital – Other Security and RBC Cushion

The **Life Risk-Based Capital (E) Working Group** discussed progress on its charges related to the Rector Report, including appropriate asset charges for “other security” held by insurers and the development of an appropriate “RBC cushion.” The Working Group stated that the current C-1 factors provide asset charges for a number of categories of “other security.” The Working Group has drafted a referral to the Valuation of Securities (E) Task Force, asking it to evaluate other types of assets, including letters of credit and parental guarantees, which could be held as “other security,” and to assist the Working Group in developing appropriate asset charges.

With respect to the development of an appropriate “RBC cushion,” Paul Graham of the ACLI submitted a letter and gave testimony commenting on the draft letter of the Working Group to the Capital Adequacy (E) Task Force, to the effect that there should be a determined capital shortfall before a ceding company is required to hold additional capital and that, relatedly, all steps should be taken to ensure that captive reinsurers are able to file necessary RBC reports.

Reinsurance Captives and NAIC Accreditation Standards

At the 2014 Summer National Meeting, the **Financial Regulation Standards and Accreditation (F) Committee** discussed proposed changes to the preambles to the NAIC accreditation standards that were released by the NAIC at the 2014 Spring National Meeting for a 45-day comment period relating to “multi-state reinsurers.” In total, the Committee received 34 comment letters. At the 2014 Summer National Meeting, the Committee left the issue open to further consideration.

The proposal would have required that, in order to maintain its NAIC accredited status, a state would have to apply the NAIC accreditation standards applicable to traditional insurers to “multi-state reinsurers,” which would have been defined as “an insurer assuming business that is directly written in more than one state and/or in any state other than its state of domicile.” The definition of

“multi-state reinsurer” covers captive insurers, special purpose vehicles and other entities assuming business even if only licensed in one state, as the definition is based on where underlying policies are written. The definition includes captives assuming XXX/AXXX risk, but also includes any captive that assumes risk written in a state other than the captive’s domestic state. Some of the standards that captives are generally not subject to currently, but would need to be applied to multi-state reinsurers under the proposal are (1) the Risk-Based Capital (RBC) Model Act, (2) valuation of investments in accordance with standards promulgated by the Valuation of Securities (E) Task Force and the Financial Condition (E) Committee, (3) the Insurance Holding Company System Regulatory Act and the related regulation (including the new Enterprise Risk Management report), (4) investment law, (5) Standard Valuation Law and Actuarial Opinion and Memorandum, (6) Credit for Reinsurance Model Law and Regulation and Life and Health Reinsurance Agreement Model Regulation (risk transfer rules), and (7) filing of annual and quarterly statutory financial statements with the NAIC.

Under the proposal, if a state did not subject multi-state reinsurers to the same NAIC accreditation standards as traditional insurers, the state could potentially lose its NAIC accreditation status, and not be recognized as an adequate state insurance regulator by the other states. The application of accreditation standards to newly defined “multi-state reinsurers” under the proposal would have only applied prospectively to reinsurance agreements entered into after July 1, 2014 on direct business written on or after July 1, 2015.

At the 2014 Fall National Meeting, Missouri Director John Huff stated that the majority of the 34 comment letters received on the proposal were in opposition to the overly broad nature of the proposed revisions and the unintended consequences. Director Huff has been working with NAIC staff to further explore the direction of the project, and he stated that the intent is to scale back the application and it is not intended to apply to pure captive transactions. Director Huff explained that the revised definition of multi-state reinsurer was an attempt to address lack of consistency and transparency in captive transactions, excluding those future transactions that meet the requirements of the XXX/AXXX Reinsurance Framework once adopted and implemented. Rhode Island Superintendent Joseph Torti echoed that the first proposal captured captives that it did not intend to capture. The Committee voted to develop new “straw man” preambles before the end of 2014 that would clarify the scope of the NAIC accreditation standards, including their applicability to reinsurance of AXXX/XXX business, variable annuities and long term care.

Financial Analysis Handbook Changes – Captive and SPV Review

The **Financial Regulation Standards and Accreditation (F) Committee** exposed a referral from the Financial Analysis Handbook (E) Working Group for a 20 day comment period. The referral includes proposed revisions to the Review Team Guidelines relating to procedures for states’ review of XXX/AXXX reinsurance transactions with captives and special purposes vehicles.

(8) PRIVATE EQUITY OWNERSHIP OF INSURERS

The **Private Equity Issues (E) Working Group** heard a presentation from Igor Rozenbilt of the SEC that provided an overview of private equity investments made in insurers. Mr. Rozenbilt advised the Working Group that private equity firms derive a significant amount of their income from management fees and that the purchase of insurers by private equity firms facilitated such firms' charging fees on the management of insurers' assets. Mr. Rozenbilt also stated that private equity firms on average generate 30% of their profits from operational improvements in companies which they purchase and that, as such, state insurance regulators should expect operational changes in purchased insurers. Mr. Rozenbilt stated that such operational strategies could lead to an increase in consumer complaints or certain populations being unable to procure adequate insurance. He also stated that acquisitions could give companies market pricing power over certain market segments, allowing them to raise prices. Mr. Rozenbilt also advised state insurance regulators to be aware of strategies involving the use of debt and subsequent issuance of dividends, the use of related party and near-related party transactions. The discussion of near-related party transactions drew particular attention from the Working Group. He advised that some ways to incentivize long-term stability include the use of earnouts and clawbacks and requiring private equity investors to create transparency through periodic disclosures. The Working Group declined to adopt the Revised Proposed Changes to the Financial Analysis Handbook that includes new guidance to state insurance regulators to be used when they evaluate the acquisition of control of insurers, including an acquisition by a private equity firm, exposing the changes to further comment.

(9) LIFE INSURER DEVELOPMENTS

Principles-Based Reserving – State of PBR Adoption

The **Principle-Based Reserving Implementation (EX) Task Force** heard an update on state implementation of principle-based reserving legislation and discussed which sections of the Standard Valuation Law should be considered in determining whether a state has adopted "substantially similar" terms and provisions for determining the operative date of the Standard Valuation Manual. The Task Force exposed for comment a proposal to use certain highlighted sections of the Standard Valuation Law that are used to determine whether legislation is "substantially similar" for accreditation purposes for the purpose of determining the operative date of the Valuation Manual. In 2015, 12 additional states are expected to adopt principle-based reserving, bringing the total to 30 states representing 60% of premium volume. Several Task Force members indicated that they expected full principle-based reserving implementation to occur on January 1, 2017. The Valuation Manual becomes "operative" the January 1 after the first July 1 when at least 42 jurisdictions comprising at least 75% of premium have adopted the Standard Valuation Law.

Principles-Based Reserving – VM-20 Small Company Exception

The **Principle-Based Reserving Implementation (EX) Task Force** discussed the VM-20 small company exemption and exposed an ACLI proposal for such exemption for comment though January 15, 2015. The proposal contemplates

the review of any such exemption within five years of the operative date of the Valuation Manual. The Life Actuarial (A) Task Force has previously discussed exempting insurers with less than \$300 million of ordinary life premiums or less than \$600 million in the case of a group of affiliated insurers. The New York member expressed strong disagreement with the proposal and voted against its exposure, describing it as a political incentive for legislators to adopt principle-based reserving and not grounded in an actuarial basis. The Kansas member agreed that there was little actuarial basis for the exclusion and that a determination of VM-20 reserves would not be overly costly, but nevertheless voted for exposure. A number of state insurance regulators and the ACLI spoke out for the inclusion of a small company exemption, arguing that compliance would be quite expensive and that the exclusion test may be less complex a few years hence, allowing for re-evaluation in five years.

Principles-Based Reserving – Implementation Support

The **PBR Review (EX) Working Group** discussed how the NAIC should provide support to state insurance regulators as principle-based reserving is implemented, as well as the progress of insurer outreach. The Working Group reported that the Valuation Analysis (E) Working Group would provide assistance in implementing principle-based reserving to state insurance regulators on a confidential basis, with a particular focus on providing guidance on any unclear aspects of the Valuation Manual. With respect to insurer outreach, the Working Group reported that plans were going forward with a pilot program whereby a consultant would work with insurers to implement principle-based reserving and identify weak spots in the implementation process. The Working Group anticipated finalizing the related request for proposal over the next six weeks, with the pilot program slated to launch on July 1, 2015.

Unclaimed Life Insurance Benefits

The **Life Insurance and Annuities (A) Committee** adopted the report of the Unclaimed Life Insurance Benefits (A) Working Group, including the adoption of the Working Group's model law development request to develop a new NAIC model law relating to unclaimed life insurance benefits. The Working Group also approved sending a comment letter to the Uniform Law Commission's Drafting Committee to inform the Committee of its recommendation to develop an NAIC model on the issue of unclaimed life insurance benefits and to urge the Committee not to revise the Uniform Unclaimed Property Act to permit the dual regulation of life insurers.

Contingent Deferred Annuities

The **Contingent Deferred Annuity (A) Working Group** adopted revisions to the Annuity Disclosure Model Regulation, Suitability in Annuity Transactions Model Regulation, Advertisements of Life Insurance and Annuities Model Regulation, and Life Insurance and Annuities Replacement Model Regulation to address contingent deferred annuities and continued its discussion of the draft "Guidelines for the Financial Solvency and Market Conduct Regulation of Insurers Who Offer Contingent Deferred Annuities." Contingent deferred annuities have been defined as "an annuity contract that establishes a life insurer's obligation to make periodic payments for the annuitant's lifetime at the

time designated investments, which are not owned or held by the insurer, are depleted to a contractually defined amount due to contractually-permitted withdrawals, market performance, fees and/or other charges.”

(10) RISK-BASED CAPITAL DEVELOPMENTS

Investment Subsidiaries

The **Capital Adequacy (E) Task Force** received a referral letter from the **Property Casualty Risk-Based Capital (E) Working Group** regarding investment subsidiaries. The Working Group exposed a proposal to change the way the RBC formula applies the charge to non-insurance investment subsidiaries. The current method is that the insurer is charged what the charge would be if the investment subsidiary filed its own statement. However, it is hard to determine the underlying assets of investment subsidiaries since they do not file statements. The proposal would change this by instead applying a flat factor to the carrying value of the common and preferred stocks and bonds. The investment subsidiary would be separated by a line item on the property/casualty RBC report so it will be clear how material these entities are for property/casualty insurers. In the future, investment subsidiaries may be moved into the non-insurance affiliate category on the report. The Working Group wanted to highlight this in the case it is relevant to life insurers. The Task Force exposed the proposal for 45 days and referred it to the Health Risk-Based Capital (E) Working Group and the Life Risk-Based Capital (E) Working Group for exposure and consideration.

RBC for Derivatives

The **Capital Adequacy (E) Task Force** exposed a referral from the Investment Risk-Based Capital (E) Working Group regarding derivatives and the RBC formula. The Working Group identified technical problems with the existing RBC instructions and calculations for life insurers and adopted changes in February 2014. The Working Group held off on moving the changes forward to see whether similar changes would be proposed for RBC for property/casualty and health insurers. The other Working Groups haven't taken it up yet and since derivatives are more significant for life insurers, the Investment Risk-Based Capital (E) Working Group decided to move their changes forward. The Task Force passed a motion to expose the life RBC formula for derivative transactions for comment until January 2, 2015.

RBC Factors and Permitted Practices

The **Capital Adequacy (E) Task Force** exposed a proposal relating to the Management's Discussion and Analysis instruction until January 2, 2015. Some insurers were adjusting RBC requirements for the calculation of Authorized Control Level RBC based on permitted practices in their domiciliary states, which caused cross check issues. This proposal clarifies that RBC factors should not be adjusted by permitted practices.

RBC Factor for Property/Casualty Reinsurance

The **Property Casualty Risk-Based Capital (E) Working Group** discussed the credit risk charge for reinsurance in the R3 Proposal. The exposure period for the proposal ended at the beginning of October and the Working Group received

several comments, which were discussed on an October 22, 2014 conference call. The proposal would change the static risk charge for reinsurance recoverables from 10% to a charge contingent on the credit rating of the reinsurer, similar if not identical to that included in the Credit for Reinsurance Model Law for certified reinsurers. The Working Group would like to either move forward with the proposal or identify specific aspects to address. There was discussion about whether unrated reinsurers should receive a higher charge of 14%. The Working Group agreed to add a new column for authorized unrated carriers and expose the proposal for 30 days.

Investment Risk-Based Capital

The **Investment Risk-Based Capital (E) Working Group** heard an update from the American Academy of Actuaries on the development of revised base asset risk factors for corporate bonds held by life insurers. The Academy is currently reviewing the previously developed model for errors and working towards developing documentation.

The ACLI submitted a letter and gave testimony raising questions about the implementation of the new risk factors and the likely effects on the portfolio allocations of life insurers. The ACLI pointed out that the changes to the C-1 factors are expected to cause significant changes to the allocation of assets with ratings from Baa to AA and sought clarity on what the proposed implementation process for the new framework would be. The ACLI also submitted a memorandum concerning potential changes to the real estate risk factors.

The Working Group referred to the Capital Adequacy (E) Task Force a proposal for changes to the RBC blanks and instructions related to pledged collateral for derivative transactions.

The Working Group heard testimony from Richard Marcks, a retired Connecticut regulator, discussing whether corollary changes to the bond charge structure for non-AVR companies (in particular, property/casualty insurers) would be advisable following implementation of the revised C-1 factors. While Mr. Marcks cautioned that changes to the non-AVR framework may not be advisable, a number of Working Group members expressed skepticism that the two frameworks were so different as to not warrant consideration of corollary changes to the non-AVR framework.

Finally, the Working Group discussed the development of asset charges for other fixed income asset classes and asked for industry support in considering these asset classes. The Working Group also stated that it may be helpful to compare data for these asset classes with data for corporate bonds.

(11) VALUATION OF SECURITIES

Alignment of State Law References to NAIC Designations

The **Valuation of Securities (E) Task Force** voted to refer to the Financial Regulation Standards and Accreditation (F) Committee a report developed by the SVO providing guidance on how to properly refer to NAIC designations and that documented inconsistency in state law references to such designations. The

Task Force stated that correcting existing inconsistencies may help states prepare for the contemplated adoption of a new NAIC credit assessment framework referred to as the “Recalibration.”

Global Financial Presentation Issues

The Task Force adopted an amendment to the Purposes and Procedures Manual to modify a reference to Canadian GAAP to refer to Canadian Accounting Standard for Private Enterprises (ASPE) and added French GAAP as a new Financial Presentation Standard in the definition of Audited Financial Statement in the Purposes and Procedure Manual. The Task Force agreed to study recent changes in the UK accounting standards that would require an amendment to the instructions in the Purposes and Procedures Manual.

NAIC Bank List

The Task Force adopted an amendment to the Purposes and Procedures Manual to make a single credit rating standard applicable to both domestic and foreign banks that apply to be listed on the NAIC Bank List as issuers of letters of credit for reinsurance credit purposes, stating that neither the Task Force nor the Reinsurance (E) Task Force, from which it received guidance, could justify different standards. The Task Force also directed the SVO to study whether all non-bank “qualified U.S. financial institutions” (the term defined in Section 4 of the Credit for Reinsurance Model Law), which are not as heavily regulated as banks, should also be subject to similar standards.

Miscellaneous

The Task Force heard a status report from NAIC staff on a proposal from the SVO that insurers file copies of private letter ratings with the SVO when the security is not in the NAIC system. The Task Force asked the SVO to continue to work with industry representatives to identify the ways to reduce the number of “false positive” filing exemptions.

The Task Force also received a report that the SEC’s adopted changes to the money market fund rules, including a rule prohibiting institutional prime funds from using Stable Net Asset Value of \$1 per share, would not impact the NAIC U.S. Direct Obligations/Full Faith and Credit List, but that the Class 1 List would be affected. The SVO recommended that the Task Force take no action at this time. The Task Force released the report for a 60 day comment period.

The Task Force received a report from the SVO on the request from the Financial Conditions (E) Committee to review the Derivative Instruments Model Regulation against the NAIC model law criteria. The SVO recommended that the Task Force study the derivatives market, instruments and regulation in order to consider whether adjustments to NAIC guidance are necessary and to formulate recommendations. The Task Force released the report for a 90-day comment period.

Finally, the Task Force heard a report from representatives from Nationwide arguing that the statutory accounting and risk-based capital treatment of catastrophe bonds should be different than the treatment for corporate

obligations generally. The representatives argued that catastrophe bonds represented an untapped source of diversification for the life insurance industry as catastrophe risk and the credit risk associated with traditional life insurance products were largely uncorrelated. The representatives postulated that adjusting the treatment of catastrophe bonds held by life insurers would also benefit property/casualty insurers by providing them with additional avenues for raising capital. Questioning whether the Financial Condition (E) Committee was the appropriate committee to hear the proposal, the Task Force received the report and released it for a 60-day comment period.

(12) OTHER MATTERS

New Cybersecurity Task Force

The **Executive (EX) Committee** approved the creation of an Executive (EX) Committee Task Force on cybersecurity that will monitor these issues and make recommendations, and coordinate activities with NAIC Committees and Task Forces.

Status of Adoption of 2010 Holding Company Model Amendments

The **Financial Regulation Standards and Accreditation (F) Committee** heard an update on the adoption of the 2010 revisions to the Insurance Holding Company System Model Act and Regulation. Thirty eight jurisdictions have enacted the revisions to the Model Act in full or in part, and many of these states have also promulgated the revisions to the Model Regulation. The 2010 revisions are required for accreditation purposes as of January 1, 2016, so all accredited jurisdictions will need to adopt the revisions during 2015. The Group Solvency Issues (E) Working Group is drafting further revisions to the Model Act to incorporate the authority to act as the group wide supervisor, but it was stated that states should still proceed with the adoption of the 2010 revisions because anything adopted by the Working Group will require a seasoning process. A commenter from the AIA cited continued confidentiality concerns, and said the AIA's support is contingent on confidentiality provisions being adopted. Director Huff responded that states are encouraged to use the Model Act, and there is always a tension between transparency and confidentiality.

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Please do not hesitate to contact us with any questions.