

NAIC 2019 Fall National Meeting Highlights

December 20, 2019

The National Association of Insurance Commissioners (“NAIC”) held its 2019 Fall National Meeting from December 7 to 10, 2019 in Austin. In this update, we highlight meeting developments of particular interest to our insurance industry clients.

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Acronyms and abbreviations used in this report:

- ACLI: American Council of Life Insurers.
- EU: European Union.
- IAIS: International Association of Insurance Supervisors.
- IAO: NAIC Investment Analysis Office.
- RBC: NAIC risk-based capital.
- SEC: U.S. Securities and Exchange Commission.
- SVO: NAIC Securities Valuation Office.

Life Insurers

Suitability in Annuity Transactions

During the 2019 Summer National Meeting, the **Annuity Suitability (A) Working Group** agreed to form a technical drafting group to develop a draft of proposed revisions to the Suitability in Annuity Transactions Model Regulation (“Model Regulation”) reflecting the Working Group’s deliberations and comments received from interested parties throughout the year.

After the Summer National Meeting, the Working Group held a conference call on September 17 and exposed a revised draft of the Model Regulation, with comments due by September 30. The Working Group then had four additional conference calls (each lasting at least two hours) in October and November to review the comments received. At its last conference call on November 5, the Working Group completed its revisions to the Model Regulation and stated that it had fulfilled its charge.

In addition to revising the text of the Model Regulation, the Working Group added two templates to be used as part of the sales process. One form provides a summary of the annuity transaction and includes information that is required to be disclosed under the revised Model Regulation, such as the producer’s role, the products that a producer is authorized to sell and the sources of the producer’s compensation. The second form is required if a consumer refuses to provide all or some of the personal financial information that is required for a producer to make a recommendation, or if the consumer decides to purchase an annuity that was not recommended.

The Working Group then referred the revised model to the **Life Insurance and Annuities (A) Committee**, whose chair immediately exposed the draft for a 21-day public comment period that ended on November 26.

At this meeting, the **Life Insurance and Annuities (A) Committee** considered each comment and then decided whether to modify the Model Regulation accordingly. The Committee completed its work and adopted the revised text of the Model Regulation, but ran out of time to consider the templates. Because the comments and proposed revisions to the templates were extensive, the Committee referred the templates back to the Working Group to discuss on a conference call that was held on December 19. The Committee also scheduled a call for December 30 to adopt the templates.

The revised Model Regulation, as adopted by the Committee, largely follows the structure of the SEC's Regulation Best Interest, with a producer's obligation to act in the best interest of the consumer deemed satisfied so long as the producer satisfies four underlying obligations: care, disclosure, conflict of interest and documentation.

The thrust of the care obligation requires a producer recommending an annuity to have a reasonable basis to believe that the recommended option "effectively addresses" the consumer's financial situation, insurance needs and financial objectives over the life of the product, as evaluated in light of the consumer's financial information. The disclosure obligation may be satisfied by using the first template described above.

The conflict of interest obligation requires a producer to disclose, identify and avoid or reasonably manage a "material conflict of interest." Notably, the Model Regulation defines "material conflict of interest" to exclude cash or non-cash compensation. Finally, the documentation obligation requires a producer, at the time of the recommendation or sale, to make a written record of the recommendation and the basis for it. A statement signed by the consumer is required if the consumer refuses to provide some or all of her financial information or decides to buy an annuity that was not recommended (as described in the second template above).

Additionally, the Model Regulation expressly states that it creates no private right of action and is not intended to subject a producer to civil liability under the best interest standard in the Model Regulation or under standards applicable to a fiduciary relationship. The Model Regulation provides a safe harbor for annuity recommendations and sales that are made in compliance with "comparable standards," which likely includes Regulation Best Interest and applicable FINRA requirements. Despite the safe harbor, the Model Regulation does not limit an insurance regulator's ability to investigate and enforce the provisions of the Model Regulation.

Finally, the Model Regulation requires insurers to establish and maintain a supervision system that is reasonably designed to achieve compliance with the Model Regulation. The supervision system must include standards and procedures to train producers, review each recommendation before issuing an annuity (which may be accomplished by an electronic screening system that identifies certain transactions for additional review) and eliminate sales contests, sales quotas, bonuses, and non-cash compensation based on the sales of specific annuities within a limited period of time.

During its December 19 conference call, the Working Group discussed each of the comments and decided to split the second template into two separate forms. The Working Group was not able to get through all of the comments and returned the revised templates to the Committee in order to finalize them during its December 30 conference call.

Property/Casualty Insurers

Big Data

The **Big Data (EX) Working Group** discussed the use of data in fraud detection and claims settlements and whether state insurance regulators have sufficient regulatory authority under existing laws, including unfair trade laws and unfair claims settlement regulations, to monitor and oversee the use of consumers' insurance and non-insurance data. While some state regulators stated that existing laws and regulations, as well as examination authority over licensed entities, provide sufficient tools to exercise their oversight function, other states' laws may offer narrower authority.

In addition, the Working Group noted the difficulty of assessing the accuracy and use of external data and algorithms created by third-party vendors, and expressed concern for the consumer's ability to be informed about how personal data is used and the ability to correct data when appropriate. Members of the Working Group noted that they would consider licensed entities, such as insurers, responsible for the use of big data in the products and services obtained from third-party vendors. During the meeting, the Working Group also heard a presentation from the Center for Economic Justice focusing on the need for greater regulatory oversight of new vendors of big data algorithms, in particular concerning the use of social media algorithms, potential disparate impacts on low-income and minority consumers, and transparency to consumers on the use of data and ability to correct inaccurate data. No motion to take specific action was taken at the meeting, and the Working Group will continue to discuss and take direction from members on moving the topic forward.

The Working Group also heard an update from the **Casualty Actuarial and Statistical (C) Task Force**, which continues to draft a white paper on best practices for regulatory review of predictive analytics, and from the **Accelerated Underwriting (A) Working Group**, which developed a work plan and will attempt to complete its consideration of the use of external data and data analytics in accelerated life underwriting in time for the 2020 Fall National Meeting.

The **Accelerated Underwriting (A) Working Group** heard a presentation on accelerated underwriting in life insurance, highlighting the following:

- Accelerated underwriting is meant to replace physical examinations and lab tests with digital information, which still allows insurers to assess an applicant's physical fitness.
- Life insurers currently use a variety of data sources for accelerated underwriting, including prescription histories, motor vehicle records, medical information bureau (MIB) reports, and applications for insurance, among others.
- A recent Society of Actuaries study of 27 life insurers found that accelerated underwriting is predominantly used for term life insurance products and that most carriers used only one algorithm, which was primarily developed in-house.
- Accelerated underwriting is designed to reduce application time but will not necessarily result in cheaper rates for consumers.

During the 2019 Summer National Meeting, the **Innovation and Technology (EX) Task Force** adopted a recommendation to appoint the **Artificial Intelligence (EX) Working Group** to study the development of artificial intelligence and its use in the insurance sector, as well as its impact on consumer protection and privacy, marketplace dynamics and the state-based insurance regulatory framework.

The **Artificial Intelligence (EX) Working Group** met in-person for the first time at the 2019 Fall National Meeting. The goal of the Working Group is initially focused on developing artificial intelligence principles for the insurance industry and developing related regulatory guidance by the 2020 Summer National Meeting. The Working Group discussed comments it received on the Artificial Intelligence Principles developed by the Organisation for Economic Co-operation and Development and exposed for public comments, until January 17, 2020, a draft of principles developed by the North Dakota Insurance Department. The Working Group expects to hold at least one conference call to discuss comments on the draft principles prior to the 2020 Spring National Meeting.

Another new addition to the NAIC's review of big data and information technology is the **Privacy Protections (D) Working Group**, which was formed in October and had its first meeting in Austin. The Working Group's charge is to review state insurance privacy protections regarding the collection, use and disclosure of information gathered in connection with insurance transactions, and make recommended changes, as needed, to certain NAIC data privacy models. The Working Group will not review data security, which deals with how information that a business has already collected and has in its possession is protected from unauthorized access. The group plans to have proposed amendments for consideration by the **Market Regulation and Consumer Affairs (D) Committee** for the 2020 Summer National Meeting.

The NAIC models being examined by the Working Group are the Insurance Information and Privacy Protection Model Act, an early data privacy model that was based on the federal Fair Credit Reporting Act and has been adopted by about 17 states, and the Privacy of Consumer Financial and Health Information Regulation, which was modeled on HIPAA and the Gramm-Leach-Bliley Act and has been adopted in some form in every state. The Working Group noted that as part of its review, it will consider recent data privacy laws, such as the European General Data Protection Regulation and the California Consumer Privacy Act. The Working Group expects to have regular conference calls beginning in 2020.

Group-Wide Supervision

Group Capital

The **Group Capital Calculation (E) Working Group** heard a report on preliminary results of the field testing exercise that took place over the summer. Thirty-two insurance groups participated in field testing, and, as of the Working Group meeting, 28 of the submissions had been reviewed. After reviewing each submission, NAIC staff met with the volunteer insurance group to discuss the results. The submissions did not reveal a substantial difference between the group capital calculations for life and annuity and property and casualty companies nor for mutual and stock companies. The field testing submissions have resulted in changes to the group capital calculation template and instructions. For example, field testing results revealed that volunteers were confused as to the definition of a regulated financial entity. NAIC staff clarified that a financial entity that is subject to a capital requirement meets the definition of a regulated financial entity. Other issues that emerged included the materiality threshold that should be used to determine whether an entity is material and whether its information should be included in the calculation and how to devise scalars for regimes in which capital required is not proportional to an entity's risk.

The Working Group will schedule a conference call to discuss next steps with respect to the development of the group capital calculation and expects to continue discussions over the next several months.

International Insurance

IAIS Activities

The **International Insurance Relations (G) Committee** heard an update on the status of key IAIS projects. At its November 2019 meeting, the IAIS adopted three key frameworks related to the supervision of internationally active insurance groups and the mitigation of insurance sector-wide risks on which it has been working for several years: (1) the Insurance Capital Standard version 2.0 (“ICS”), (2) the Holistic Framework for Systemic Risk in the Insurance Sector and (3) the Common Framework (“ComFrame”), including a revised set of Insurance Core Principles.

Over the next several months, multiple NAIC groups will review the frameworks to determine whether there are areas in which the U.S. regulatory system does not meet the supervisory expectations of ComFrame. For example, the **Group Solvency Issues (E) Working Group** will hold a workshop to assist supervisors who conduct supervisory colleges to ensure that the colleges meet ComFrame principles and will also develop a frequently asked questions document for regulators to provide clarification about ComFrame implementation. In addition, the Working Group’s 2020 charges include assessing ComFrame and making recommendations on its implementation in a manner appropriate for, and consistent with, the existing U.S. regulatory framework.

Members of the Working Group noted that they expect that the current U.S. system already reflects most of the elements of ComFrame, but the Working Group’s first task will be to perform a gap analysis. The Working Group noted that it may be necessary to update the Insurance Holding Company System Regulatory Model Act and the Insurance Holding Company System Model Regulation (the “Holding Company Act Models”) to address any gaps that are identified. In addition, the Working Group heard that the **Group Capital Calculation (E) Working Group** had submitted a model law development request to the **Executive (EX) Committee** with respect to revising the Holding Company Act Models to permit the confidential collection and submission of data necessary to calculate group capital.

The NAIC has stated that it does not intend to adopt the ICS, for which the IAIS will begin a five-year monitoring period starting in January 2020. A jurisdiction-neutral aggregation method developed by the NAIC, in collaboration with other international insurance supervisors, will be submitted to the IAIS to assess comparability with the

ICS. At its November 2019 meeting, the IAIS released a definition of comparable outcomes and an approach to developing the criteria that will be used to assess comparability, as well as a timeline for the development.

The NAIC released a set of interpretive principles, which the **International Insurance Relations (G) Committee** expects will be used as a base to develop the IAIS's more comprehensive set of principles that will be used to assess comparability. The IAIS intends to hold a consultation on the definition of comparability in mid-2020, with subsequent consultations on the criteria of the comparability assessment and the ICS as a prescribed capital requirement. The Committee clarified that the group capital calculation would be the U.S.-specific version of the aggregation method. The Committee and the chair of the **Group Capital Calculation (E) Working Group** also stated that the group capital calculation for U.S. purposes will not include supervisory intervention powers, but noted that there are a number of issues that will need to be resolved with respect to the ICS and the aggregation method over the course of the monitoring period, including with respect to any prescribed capital requirement.

Because the IAIS has adopted ComFrame, the **ComFrame Development and Analysis (G) Working Group** will be dissolved. The Committee will continue to monitor and provide input to NAIC committees as ComFrame is implemented.

Reinsurance

The **Financial Regulation Standards and Accreditation (F) Committee** adopted the revisions to the Credit for Reinsurance Model Law and the Credit for Reinsurance Model Regulation (the "Models") to incorporate the EU Covered Agreement and a similar agreement with the United Kingdom as accreditation standards. The Committee explained that because the Federal Insurance Office will begin its preemption analysis in early 2021, all states should adopt the revised Models no later than September 1, 2022, to be effective by January 1, 2023.

Furthermore, although a state's compliance with an NAIC accreditation standard typically is determined by whether the language adopted by the state is "substantially similar" to the applicable NAIC model, in this case, the NAIC will require states to adopt language that is "close to identical" to the revised Models in order to be in compliance with this accreditation standard. The Committee stated that this higher level of compliance is necessary to reduce the risk of federal preemption to the greatest extent possible.

The Committee, somewhat surprisingly, also adopted the Term and Universal Life Insurance Reserve Financing Model Regulation (also referred to as the "XXX/AXXX Credit for Reinsurance Model Regulation") as a new accreditation standard effective

September 1, 2022. The adoption of this model as an accreditation standard had been delayed while the NAIC worked through the amendments to the Models required for the Covered Agreement.

Financial Condition

Valuation of Securities

The **Valuation of Securities (E) Task Force** exposed proposed revisions to the Purposes and Procedures Manual of the IAO (“P&P Manual”) to remove financial modeling instructions for RMBS/CMBS securities and direct IAO staff to produce a single NAIC designation and designation category for modelled assessment of credit risk for RMBS/CMBS securities. Beginning in 2020 for RMBS and CMBS, NAIC designations and designation categories will be assigned by the NAIC Structured Securities Group (“SSG”) based on SSG’s assessment of the credit risk of these securities. This is a change from the SSG’s current practice of providing book-adjusted carrying value breakpoints for each NAIC designation category to determine NAIC designations, which would have added significant complexity as a result of the expansion of NAIC designation categories from 6 to 20 levels of credit risk. The proposed revisions are considered substantive and the Task Force has provided for a comment deadline of February 7, 2020.

In addition, the Task Force received a report from the SVO regarding proposed updates to the definition of principal protected notes (“PPNs”) that were exposed during the 2019 Summer National Meeting. PPNs are a type of structured security where a portion of the underlying assets are dedicated to ensure the repayment of principal at maturity or a third party may guarantee the repayment of principal at maturity. The remaining assets in the structure, the performance assets, are intended to generate additional returns and may be of a type that would not be eligible for reporting on Schedule D. These may include derivatives, equities, commodities, non-rated debt, loans, funds, private equity, real estate or other similar assets. The SVO staff recommended that PPNs not be eligible for a filing exemption under the P&P Manual and that the SVO review such securities based on SVO methodologies using a look-through approach. The SVO has been working with the industry to refine the definition of PPNs included in the exposed revisions.

The Task Force also raised concerns about repackaging investments into PPNs to receive more favorable RBC charges than would otherwise be assigned to the investments underlying the PPNs if held directly by an insurer. While no proposed revisions or definition was exposed during the meeting, the Task Force expects to expose a definition of PPNs as well as a new section of the P&P Manual. Given the

magnitude of the expected revisions, the Task Force does not expect to expose proposed revisions until next year, potentially on or around February 15, 2020, with additional discussion to occur at the 2020 Spring National Meeting.

Risk-Based Capital Developments

The **Capital Adequacy (E) Task Force** adopted proposed revisions to the RBC Preamble, to state that “there are no state permitted practices to modify the RBC formula and all insurers are required to abide by the RBC instructions.” Prior to the meeting, the Task Force received an informal comment that there may be state insurance regulators that allow carriers to modify the RBC formula, which may cause a disconnect between the information set forth in the statutory financial statements and the RBC formula. There was significant discussion at the Task Force meeting about such practices, with members noting that when a domiciliary state grants a permitted practice that deviates from statutory accounting principles, other state regulators are provided with notice and an opportunity to discuss the permitted practice. But in the case of a permitted practice that modifies the RBC formula, no such notice is provided to other states. A majority of the Task Force agreed that there should not be any modification to the RBC formula and adopted the proposed revisions. The Task Force also agreed to revisit the question as to whether state regulators have granted permitted practices with respect to the RBC formula.

Collateralized Fund Obligations

During the 2019 Summer National Meeting, the **Statutory Accounting Principles (E) Working Group** discussed proposed revisions to SSAP No. 43R (Loan-backed and Structured Securities) that have the potential to affect insurer capital charges for holding investments in collateralized fund obligations (“CFOs”) and similarly structured products. The proposed revisions are intended to require insurers that invest in structures that are issued in the form of bonds or debt instruments, but have return characteristics that are equity-like, to report such investments on Schedule BA rather than Schedule D.

At this National Meeting, the Working Group briefly noted that it will continue to discuss proposed revisions to SSAP No. 43R on a January 8, 2020 conference call given the detailed discussions with interested parties and comments received. Materials, including comments received from interested parties, will be released a week prior to the conference call. Interested parties should expect a subsequent re-exposure of proposed revisions following the conference call.

Statutory Accounting

The **Statutory Accounting Principles (E) Working Group** proposed revisions to SSAP No. 25 (Affiliates and Other Related Parties) that would clarify that the holder of a non-controlling ownership interest greater than 10% is a related party and subject to related party disclosures for statutory accounting purposes, regardless of any disclaimers of affiliation or disclaimers of control approved by a domiciliary state under a state's Insurance Holding Company Act. The exposure is classified as non-substantive and an exposure of a blanks exposure is anticipated to occur concurrently with this exposure. The deadline for comments from interested parties is January 31, 2020.

Commissions

The **Statutory Accounting Principles (E) Working Group** re-exposed proposed revisions to SSAP No. 71 (Policy Acquisition Costs and Commissions) regarding persistency commissions and levelized commission arrangements to address interested party comments to the revisions exposed at the 2019 Summer National Meeting. The exposed revisions provide that a levelized commission arrangement requires the establishment of a liability for the full amount of unpaid principal and accrued interest payable to a third party at the time the policy is issued, and that persistency commission arrangements accrue proportionately over the policy period to which the commission relates and is not deferred until fully earned. The revisions are intended to require recognition as commissions are incurred and reject an accounting treatment that defers expense recognition because that does not reflect generally accepted statutory accounting treatment.

The Working Group and NAIC staff agreed that the exposed revisions would benefit from additional edits to address industry concerns that guidance as exposed could be interpreted to require a traditional persistency commission to be accrued for multiple years up front. In the case of true persistency where an agent is paid annually, the Working Group's intent is to accrue annually if an annual persistency commission is payable, and not to accrue more than is being paid to the agent each year. However, the establishment of a liability for the full amount of the unpaid principal and accrued interest payable to a third party is required where a levelized commission arrangement is used but the commissions are linked to repayment of an advance amount, rather than traditional elements of a policy, such as premium payments and policy persistency. In such a case, the levelized commission arrangement functions more like a funding agreement.

The Working Group continues to view the proposed revisions as "non-substantive," which means that they are meant to clarify the scope of SSAP No. 71, rather than substantively change the meaning. Interested parties continued to offer critical comments on this classification, noting that the proposed revisions substantially change

the accounting paradigm for levelized commissions and may have significant unintended consequences to statutory accounting for commissions.

The Working Group agreed to re-expose the proposed revisions to allow for further discussions but did not change the non-substantive classification. The comment deadline for new and exposed items is January 31, 2020.

Restructuring

Insurance Business Transfers

The **Restructuring Mechanisms (E) Working Group** received final restructuring principles from ACLI and the American Property Casualty Insurance Association. Of particular interest to Working Group members was the suggestion that an independent expert must be utilized as part of a restructuring transaction. Some Working Group members observed that the use of an independent expert should be at the discretion of the regulator, rather than a requirement. A representative of the Oklahoma Insurance Department, which recently approved an insurance business transfer transaction between affiliates, reported that it used an independent expert as part of its review process. The independent expert reported to the Oklahoma Insurance Department, which worked closely with the expert to ensure that all appropriate analyses were performed. A consumer advocate noted that analyses by independent experts tend to focus on financial outcomes, rather than broader policyholder experiences and suggested that a policyholder advocate also be part of the review process.

The Working Group also received a position statement from the National Conference of Insurance Guaranty Funds, saying that business transferred pursuant to a corporate division or insurance business transfer statute should neither gain nor lose guaranty fund protection as a result of the restructuring transaction. The Working Group heard a presentation from NAIC staff on guaranty fund protection for segregated accounts and protected cells, including the staff's preliminary conclusion that guaranty fund coverage will not extend to business transferred into a protected cell, and that an amendment to the Guaranty Association Model Acts may be required to remedy this gap.

Receivership

The **Receivership and Insolvency (E) Task Force** plans to hold a conference call to discuss methods for ensuring the continuity of essential services and functions once an insurer is placed into receivership. Members of the Task Force noted that the NAIC's model laws and regulations do not fully address this issue. Because the Insurer Receivership Model Act has not been widely adopted, the Task Force may explore other

implementation methods, such as an amendment to the Holding Company Act Models. Additionally, the Task Force will delegate to the **Receivership Law (E) Working Group** the task of developing recommendations for methods to encourage states to adopt certain receivership practices that are critical for multi-state receiverships.

Finally, the Task Force exposed draft guidance for the Receiver's Handbook for Insurance Company Insolvencies related to best practices in handling taxes and federal releases in receiverships. The comment period will end on January 31, 2020.

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Please do not hesitate to contact us with any questions.

[Click here](#) for a recording of the recent NAIC Summer National Meeting client briefing highlighting these topics.

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