# Client Update
# NAIC 2017 Summer National Meeting

The National Association of Insurance Commissioners (NAIC) held its 2017 Summer National Meeting from August 6 to 9, 2017 in Philadelphia. This client update highlights developments from the Meeting 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.
- "G-SII" means a global systemically important insurer.
- "IAIS" means the International Association of Insurance Supervisors.
- "IAO" means the NAIC Investment Analysis Office.
- "IMF" means the International Monetary Fund.

- "ORSA" means Own Risk Solvency Assessment.
- "PBR" means Principle-Based Reserving.
- "RBC" means NAIC risk-based capital.
- "SIFI" means a systemically important financial institution.
- "SVO" means the NAIC Securities Valuation Office.

## (1) LIFE INSURERS

### Suitability in Annuity Transactions

**The Annuity Suitability (A) Working Group** continued to consider potential revisions to the Suitability in Annuity Transactions Model Regulation ("Model Regulation") and to consider how to better promote uniformity across jurisdictions in the area of annuity suitability. The Working Group heard a number of proposals from consumer advocates for revisions to the Model Regulation. Proposals include adopting a fiduciary or "best interests" standard (instead of the current suitability standard) and substantive prohibitions on conflicts of interest (rather than disclosure or management of such conflicts), as well as expanding the Model Regulation beyond annuities to apply to sales of investment-type life insurance, such as indexed universal, variable universal and whole life.

New York expressed support for expanding the Model Regulation to investment-type life insurance, noting that, since these products likely will be covered under the U.S. Department of Labor ("DOL") fiduciary rule, not doing so would create a regulatory gap. New York also suggested surveying how investment-type life insurance products are marketed.

The ACLI expressed support for a single uniform standard of care applicable to annuities transactions, and did not object to incorporating a "best interest" standard of care, but not as it is currently defined by the DOL fiduciary rule. However, the ACLI did not favor expanding the Model Regulation, contending that existing NAIC rules designed for life insurance are sufficient and that forcing life insurance into the existing Model Regulation structure would not be a good fit.

### Reinsurance

The **Reinsurance (E) Task Force** considered whether to include as "significant elements" of the accreditation standard for the Term and Universal Life Insurance Reserve Financing Model Regulation ("XXX/AXXX Model Regulation") the prohibition against engaging in transactions designed to circumvent the purpose and intent of the XXX/AXXX Model Regulation and the enabling authority provision of the Credit for Reinsurance Model Law, which gives regulators authority to adopt NAIC model solvency regulations for other types of life insurer captives, including variable annuity and long-term care captives. The Task Force adopted the prohibition

referred to in the previous sentence as a significant element of the accreditation standard but not the enabling authority, and referred its findings to the **Financial Regulation Standards and Accreditation (F) Committee**.

The Task Force received a status report on the implementation of various model laws and regulations. The 2011 version of the Credit for Reinsurance Model Law has been adopted by 41 states, and the 2011 Credit for Reinsurance Model Regulation has been adopted by 33 states, covering more than 70% of direct insurance premiums written across all lines of business. In addition, 12 states have adopted the 2016 revisions to the Credit for Reinsurance Model Law.

### Surplus Note Accounting

At the 2017 Spring National Meeting, the **Statutory Accounting Principles (E) Working Group** exposed proposed amendments to Statutory Accounting Principle No. 41R-Surplus Notes (SAP 41) to provide guidance and illustrations for accounting for surplus notes issued at a premium or discount, or as zero coupon notes. The amendments would forbid issuances of surplus notes at more than a de minimis discount because they would not satisfy the requirement of SAP 41 that surplus notes be issued in exchange for cash or other admitted assets with a readily determinable value and liquidity.

The proposed amendments were exposed for comment and discussed by the Working Group during a June 8, 2017 conference call. At that time, the Working Group directed NAIC staff to redraft the proposal using a different approach for discounted and zero coupon surplus notes.

At the 2017 Summer National Meeting, the Working Group exposed for a 30-day comment period a revised proposal based on the principle that the net balance of a surplus note issued (including in exchanges or through amendments of terms) at a discount or zero coupon should never be greater than the amount of cash and liquid admitted assets received by the insurer and that the amount of discount should be recorded as a liability. The revisions to SAP 41 provide specific accounting guidance for certain transactions consistent with that principle, and require disclosure of discount or zero coupon surplus note information in the financial statements.

## (2) PROPERTY/CASUALTY INSURERS

### Big Data

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

The proposal involves the creation, within the NAIC, of a Predictive Analytics Team ("PAT"), which would review certain complex rating models that insurers file with their state rate filings, and a Predictive Analytics Working Group ("PAWG"), which would develop a checklist of data that companies would have to provide as part of their rate filings. The PAT would consist of NAIC employees with actuarial, insurance and predictive analytics modeling experience. The PAWG would have five to ten regulatory actuaries appointed by the chair of the **Property and Casualty Insurance (C) Committee** in consultation with the chair of the Working Group.

The proposal contemplates that insurers would file their rate requests with the states using the NAIC's electronic filing system, as they do now, and would include all data required by the PAWG checklist with respect to models used in the development of the filed rating plan. The state would determine whether the filing is an update to a previously approved model or a new model that had not been filed previously. It would then decide whether to refer the model to the PAT for review or review the model on its own. The PAT's role would be to serve as a technical consultant to the state.

The PAT would consider whether the model was constructed properly and appropriate data sets were used for testing/validation, whether variables used in the model were statistically significant in predicting loss, as well as the presence of proper governance and controls on the model and data quality. The PAT would not offer an opinion on whether any rating variable used in the model violates a state's public policy, and the state would be free to reject any conclusions reached by the PAT.

In comments submitted on the proposal, industry and consumer representatives expressed concerns about the delegation of authority to NAIC staff, the protection of insurers' confidential trade secrets, the qualifications of individuals reviewing the models, and the lack of due process and transparency.

The Working Group emphasized that the intent of the proposal is to maintain state authority while improving the speed to market of insurance products that use these models, and to provide a centralized review mechanism to enable information sharing among the states. A regulator suggested a system of memoranda or other contractual arrangements between individual states and the NAIC to address concerns about delegating a regulatory function and members of the Working Group seemed amenable to this proposal.

The Working Group noted that it was not making a final decision about whether this proposal was the appropriate framework, but was gathering opinions about what adjustments may need to be made.

## (3) CYBERSECURITY

The **Cybersecurity (EX) Working Group** adopted the Insurance Data Security Model Law (the "Model Law") with three members of the Working Group dissenting. The Model Law was later adopted by the **Innovation and Technology (EX) Task Force**, with one negative vote.

The Model Law took over a year to draft and was the subject of hundreds of pages of comments. The Model Law sets forth broad standards applicable to any insurance licensee in designing and implementing an information security program and identifies certain actions that a licensee must take when it learns that it has been the subject of a data breach. The Working Group clarified that the Model Law is intended to apply not only to cybersecurity breaches but also to breaches of information stored in paper or other forms. As the Model Law adopts features of New York's cybersecurity regulation, the Working Group noted that licensees who comply with New York's cybersecurity regulation will also be deemed to be in compliance with the Model Law. For more information, see our August 11, 2017 client update.

## (4) INTERNATIONAL INSURANCE ISSUES

### U.S.-EU Regulatory Relations

On July 14, 2017, the U.S. Department of the Treasury and the Office of the U.S. Trade Representative announced their intent to sign the Bilateral Agreement between the U.S. and the EU on Prudential Measures Regarding Insurance and Reinsurance (the "Covered Agreement"), which addresses group supervision, reinsurance and the exchange of information between supervisory authorities. The Administration also announced plans to issue a U.S. policy statement on the implementation of the Covered Agreement that may provide additional guidance and specificity. This announcement was cited at several of the NAIC meetings as a basis for delaying action on certain NAIC matters that may be impacted in unknown ways because of the Covered Agreement.

At the 2017 Summer National Meeting, the **Financial Regulation Standards and Accreditation (F) Committee** was expected to adopt as new accreditation standards the Corporate Governance Annual Disclosure Model Act and Model Regulation and the 2014 revisions to the Insurance Holding Company Model, which provide for states to become designated to act as a group-wide supervisor of an internationally active insurance group. The Committee voted to defer adopting any new accreditation standards until there is greater certainty with respect to the impact of the Covered Agreement and the to-be-issued policy statement on corporate governance and group supervision. Several regulators expressed concern about potentially having to go back to their state legislatures for additional amendments to the Model Laws to reflect Covered Agreement requirements. The Committee voted to monitor work related to the Covered Agreement and to consider any developments at the next NAIC annual meeting in December 2017.

Under the Covered Agreement, reinsurance collateral requirements would be eliminated for EU reinsurers that maintain a minimum amount of "own funds" equivalent to $250 million and a solvency capital ratio of 100% under Solvency II. U.S. reinsurers that maintain capital and surplus equivalent to €226 million with an RBC of 300% of Authorized Control Level would not be required to maintain a local presence in the EU in order to do business in the EU. After the Covered Agreement goes into effect, states will have five years to implement their reinsurance provisions or face potential preemption by the FIO.

In light of the uncertainty related to the impact of the reinsurance provisions of the Covered Agreement, the **Reinsurance (E) Task Force** directed the **Qualified Jurisdiction (E) Working Group** to terminate further work on its report on the implementation of Solvency II by EU member states and the potential impact on the existing qualified jurisdiction status of France, Germany, Ireland and the United Kingdom. The Task Force noted that additional work on the report would not be needed at this time because the Covered Agreement would address the issue of qualified jurisdictions and reinsurance collateral requirements.

**IAIS Activities**

The **International Insurance Relations (G) Committee** heard a report on IAIS activities. The IAIS is nearing the end of its fifth assessment of G-SIIs. Currently, prospective G-SIIs and regulators are exchanging information, and the FSB will consider the list of recommended G-SIIs in November. The IAIS's new group, the Systemic Risk Assessment Task Force, continues to build on the work of the NTNI task force and revisions to the G-SII assessment methodology to create a holistic framework for systemic risk assessment and measurement. The Systemic Risk Assessment Task Force intends to release an interim public consultation on cross-sectoral risk assessment and the activities-based approach by the end of 2017.

The Property Casualty Insurers Association of America noted that it had become aware of a work stream among the FSB, IAIS and IMF related to the examination of potential data gaps with respect to G-SIIs and questioned why there was not greater transparency with respect to this work. A representative of the IAIS Secretariat noted that the work stream is not very developed.

The IAIS released Insurance Capital Standard 1.0 for extended field testing on July 21 with an expanded list of field testing volunteers. The IAIS aims to eliminate some of the options it has set forth through data collection, although key issues such as valuation, capital resources, capital requirements and approaches to implementation remain outstanding. In addition, Insurance Core Principles ("ICPs") 1, 2, 18 and 19 have been released for public consultation. Draft NAIC comments have been circulated with input due by August 21, 2017. The Committee will hold a conference call on August 24, 2017 to discuss and approve its comments by August 29, 2017. ICP 24 was released for public consultation with comments due October 1, 2017. The NAIC has started its internal review, and the Committee plans to hold conference calls in September to

discuss its comments. Finally, the IAIS has decided to create a virtual group of FinTech subject matter experts, who will put together a workplan for 2018-2019.

## (5) GROUP-WIDE SUPERVISION

### Group Capital

The **Group Capital Calculation (E) Working Group** continued its work on technical issues related to the development of a methodology for calculating group capital. The Working Group discussed a memorandum from NAIC staff about the treatment of captive insurers in a group capital calculation. The memo has been exposed for 30 days with comments due by September 5, 2017. The memo focuses on four categories of captives: (1) those that are not part of a traditional U.S. insurance holding company; (2) pure captives; (3) captives that assume no XXX/AXXX business; and (4) captives that assume XXX/AXXX business.

The Working Group tentatively agreed with the memo's recommendation that captives that are not part of a traditional U.S. insurance holding company should not be subject to a group capital calculation, while pure captives should receive the same treatment as non-insurance affiliates. The Working Group also tentatively agreed with the memo's recommendation that captives that do not assume XXX/AXXX business should complete the RBC blank using their own basis of accounting with adjustments.

The Working Group noted that most comments focused on captives that assume XXX/AXXX business. The memo proposes that these captives use the same accounting basis as the direct writer of the business, provided that direct insurers should be able to use PBR for in-force and new business ceded to captives already in existence. The memo sets forth four questions related to asset and liability valuation for these captives. In addition, the ACLI proposed adding a fifth question to the exposed memo regarding how policies that are grandfathered under the NAIC XXX/AXXX Framework should be treated in the group capital calculation, which the Working Group agreed to add.

The Working Group also discussed the appropriate way to handle prescribed and permitted practices. The Working Group noted that there is widespread consensus that prescribed and permitted practices should not be ignored in creating the group capital calculation but that opinions diverge as to whether there should be adjustments in the calculation for such practices or whether such practices should be respected as embedded in the state-based system. The Working Group instructed NAIC staff to collect data with respect to such practices and seek to understand any interaction with the baseline exercise that the NAIC staff is currently undertaking.

The Working Group also considered jurisdictions for which scalars should be developed. The Working Group noted that over time, scalars should be developed for each jurisdiction, but that

there will likely be a smaller list of jurisdictions for which scalars are created when the group capital calculation is first launched. The Working Group instructed NAIC staff to begin calculating scalars for jurisdictions in which an average capital ratio is available.

Finally, the Working Group heard an update on the baseline exercise, which is close to the end of its second round of data collection from volunteer insurers. The Working Group declined to share the technical specifications of the data collection template with non-volunteers.

## (6) LONG-TERM CARE INSURANCE

Multiple NAIC task forces and working groups have been focusing on issues related to long-term care insurance, including potential funding mechanisms, run-off options, impact of receivership and guaranty fund requirements and actuarial guidance.

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

The **Executive Committee and Plenary** adopted Actuarial Guideline LTC ("AG LTC") addressing the application of asset adequacy testing to long-term care insurance reserves. The intent of AG LTC is to provide uniform guidance and clarification of requirements for the appropriate support of certain assumptions for the asset adequacy testing applied to a company's long-term care block of contracts. The guideline is effective for reserves reported as of December 31, 2017 and subsequent annual statements.

AG LTC provides, in relevant part: (1) that asset adequacy analysis may be in the form of a gross premium valuation or in a more robust form, such as cash flow testing, with Actuarial Standards of Practice providing guidance; (2) that a uniform approach must be used to support acceptable assumptions regarding future long-term care premium rate increases; and (3) documentation requirements for assumptions associated with all key long term care risks and standalone long-term care asset adequacy testing results.

In addition, during a July 19, 2017 conference call, the **Joint Long-Term Care Insurance Task Force of the Health Insurance (B) Committee and the Financial Condition (E) Committee** heard a presentation on a proposed long term care run-off facility from a major accounting firm and a run-off specialty company. The proposed run-off facility would not address the issue of obtaining additional funding to support long-term care liabilities, but rather focused on offering economies of scale through consolidation, transparency and claim and reserving practices. The

goal of the run-off facility is to be used to run off long-term care claims for both solvent and troubled insurers.

Under the proposal, the facility would effect a novation from one carrier to another by using a court-supervised process that relies on extensive financial disclosure, notice provisions and independent valuation requirements to protect policyholders' rights. As conceived, the facility would not result in any change to the terms and conditions of the contract; only the obligor would change. The novation would require approval from the regulators of both the transferring and transferred insurer, and the judicial review process would provide policyholders the ability to be heard.

The proposed run-off facility would attract investors to provide liquidity for an insurer's underfunded long-term care obligations and would utilize market tools such as hedges and swaps to mitigate future exposures that might not be as easily achieved within individual insurers.

Regulators and consumer advocates stressed that policyholder protection is paramount and that, as proposed, mechanisms to protect consumers would need to be strengthened. For example, the opportunity to be heard in the judicial process may not provide adequate protection if practical obstacles, such as travel or legal expenses, prevent individual policyholders from expressing their views. They also noted that the facility may require premium rate increases and questioned its impact on policyholder consent rights in order to transfer their policy to a new assuming carrier.

## (7) VALUATION OF SECURITIES TASK FORCE

The **Valuation of Securities (E) Task Force** adopted a report from the IAO responding to a referral from the **Investment Risk-Based Capital (E) Working Group** and referred the report to the Working Group. The report states that the IAO will create a new NAIC designation category to produce the required 20 delineations of credit assessment that the Working Group requires to increase the granularity of the RBC framework. The Task Force clarified that the IAO would prepare a straight-forward mapping of NAIC credit ratings to the ratings by third-party credit rating providers. The Task Force directed NAIC staff to coordinate a meeting between the Task Force, the Working Group and the **Capital Adequacy (E) Task Force** to consider the adoption of the proposed increase in granularity.

## (8) FINANCIAL STABILITY TASK FORCE

### Macro-prudential Monitoring

The **Financial Stability (EX) Task Force** heard an update on the NAIC Macro-Prudential Initiative (the "Initiative"), which focuses on four areas for potential enhancement: liquidity, recovery and resolution, capital stress testing and identifying exposure concentrations. The

Initiative is envisioned as a two- to three-year project. The Initiative's first project will focus on liquidity, and the Task Force appointed a Liquidity Assessment Subgroup to lead this effort. The Subgroup's charges are to: (1) review existing data related to liquidity risk, identify any data gaps based on regulatory needs and propose the companies to which any recommendations may apply and (2) construct a liquidity stress testing framework proposal for consideration by the **Financial Condition (E) Committee**. The work plan envisions the data review and identification of gaps to be completed by the 2017 Fall National Meeting with the Subgroup's charges to be completed by the 2018 Summer National Meeting. A number of large insurers expressed their support of the Initiative.

The Task Force also discussed the concept of a new NAIC Macro-Prudential Heat Map Report, which would classify risks into various risk categories. Several questions about using such a heat map were raised including how judgments about the risks would be made and by whom.

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Please do not hesitate to contact us with any questions.

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

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