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2013 YEAR END REVIEW AND FORECAST FOR 2014

2013 INSURANCE INDUSTRY YEAR END REVIEW AND FORECAST FOR 2014

The tectonic plates of insurance regulation are shifting – with reverberations across the industry. The industry is also faced with significant commercial pressures, including a flood of third-party capital; persistent historically low investment returns, which are driving insurers to search for yield and restructure their businesses; and a flurry of M&A activity, particularly cross-border acquisitions, as insurers seek top-line growth and diversification.

This *2013 Insurance Industry Year End Review* contains our catalogue and analysis of some of the key commercial and regulatory developments of the past year, as well as some prognostications regarding the coming year(s). Some sections are general, some are highly detailed. We encourage you to use the table of contents to find the material of greatest interest to you, and look forward to your thoughts and comments on the issues and on our annual review and forecast.

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REGULATORY – GLOBAL

There has never been a period of greater change in insurance regulation. The speed and scope of developments are unprecedented. These changes go to the heart of the day-to-day operations, structure, capital base and business opportunities of insurers globally and in domestic markets. Even the *dramatis personae* of the regulatory world are changing. New players are emerging with significant new power and influence. The emerging powers include the Financial Stability Board (FSB), Federal Insurance Office (FIO), Federal Reserve, Federal Stability Oversight Counsel (FSOC), Consumer Financial Protection Bureau, and influential national regulators, many from outside of the US.

Some of the dominant global trends and developments (discussed in greater detail infra) include:

- **Evolution of Group Supervision**

One of the hottest topics is the regulation of insurance groups. Regulators are acting in the US (via the NAIC Solvency Modernization Initiative), Europe (via Solvency II) and globally (via the IAIS' development of ComFrame).

In the US, this focus has led to amendments to the Insurance Holding Company System Model Act and Model Regulation that added a new requirement regarding filing enterprise risk management (ERM) reports and instituting new authority for regulators to conduct supervisory colleges, the development of an Own Risk and Solvency Assessment Program, and the initiation of work on new corporate governance standards. Although questions remain regarding how many states will adopt these new NAIC models, as an institution the NAIC and its member commissioners clearly see group supervision as one of the major regulatory challenges they face in the coming years. The FIO report on insurance regulatory modernization has echoed this concern.

The most significant development regarding group supervision, however, is the *Common Framework for the Supervision of Internationally Active Insurance Groups* (ComFrame) initiative of the IAIS. As described by the IAIS, "ComFrame is an integrated, multilateral and multidisciplinary framework for the group-wide supervision of internationally active insurance groups, or 'IAIGs'." Although the IAIS asserts that ComFrame "builds on, and complements, the IAIS Insurance Core

Principles" that theoretically apply to all insurers and insurance regulatory systems, ComFrame in fact proposes far reaching new requirements for the newly defined clan of insurers labeled internationally active insurance groups.

- **New Capital Standards**

Many would argue that one of the areas least in need of regulatory reform is capital adequacy standards. Nevertheless, there is significant activity underway. For more than a decade, Europe has been laboring mightily on the development of new solvency rules known as Solvency II. A key aspect of Solvency II is a new generation of capital requirements, established through the use of capital models (either a standard model created by regulators or a bespoke internal model, created by insurers but approved by regulators). Other countries – including China, Mexico, and Australia –

have established new solvency rules that are based partly on Solvency II, the US RBC system, or are hybrids. This diversity has stimulated significant competition between EU and US regulators to capture the hearts and minds of the global regulators as to which system is best – and which should be replicated. The debate over capital standards has moved to a new level as the IAIS begins to establish new capital rules for globally systemically important insurers (G-SIIs) and makes plans for establishing new "Insurance Capital Standards" to apply to all large international insurance groups.

- **Identification and Regulatory Reaction to Systemically Important Insurers – SIFIs or G-SIIs**

"Too big to fail." "Systemically important." Do these phrases apply to the insurance industry? Perhaps no other regulatory concept has been debated as hotly this year. The FSB's decision to designate nine insurance groups as systemically important, and the FSOC's decision to designate three, has touched off debates about whether the designations make sense. Both organizations are certainly considering future designations.

The FSB and FSOC designations have also generated secondary, but equally important debates about what additional regulatory rules should apply to this special fraternity of insurers. And this in turn raises the question whether these new rules should apply to other insurers who may not be deemed "systemically" important, but which are important because they are large and internationally active.

- **Regulatory Reaction to the Role of Third-Party Capital in the Insurance Industry**

Insurers and reinsurers have been watching and reacting to the flow (some would say flood) of third-party capital into the insurance industry – both life and non-life. Third-party capital is having a substantial impact on the commercial front, moving from the fringe to a multibillion-dollar segment of the market. Regulators have started to take notice of these transactions. Most argue that third-party capital is not a fad or fleeting phenomenon, but now a permanent part of the industry. How third-party capital is raised and deployed and how it continues to grow in the industry is discussed in the Commercial and Transactional Issues and Trends section of this Annual Review and Forecast.

The IAIS' power is derived from (and limited by) its ability to achieve consensus among powerful national regulators on new regulatory principles and from dictates by the FSB and other organizations

These and other issues are discussed in greater detail below. In light of these developments, it is fair to say that never have there been so many disruptive new elements entering the insurance industry, in both the regulatory and commercial arenas.

The Rising Influence of the IAIS

The rallying cry – "Our Time has Come" – is most appropriate for the IAIS. The IAIS will celebrate its 20th anniversary this year. As it does, it finds itself the dominant voice on international insurance regulatory matters. The IAIS has enthusiastically embraced its role as the "standard setting body" for the insurance industry. It has been so designated by the FSB, and that makes it the insurance industry equivalent of the Basel Committee for banking and the International Organization of Securities Commissions (IOSCO) for the securities industry. This is pretty heady stuff for an organization that, when it was formed, specifically committed to its members that it would not be a standard setting body or seek to impose standards on member countries. From its new seat of power and influence, the IAIS has led the way on a number of initiatives, including the development of ComFrame, insurance capital standards, identification of systemically important insurers, branch regulation and other matters. As a result, the IAIS has influenced insurance regulation at the national and local levels around the world.

The IAIS' power is derived from (and limited by) its ability to achieve consensus among powerful national regulators on new regulatory principles and from dictates by the FSB and other organizations who look to or call upon the IAIS to lead the development of new regulatory rules.

Unquestionably, the two most significant and ambitious IAIS projects are ComFrame and the development of insurance capital standards.

ComFrame. The IAIS has been working on developing ComFrame since 2010. In October 2013, the IAIS released for public consultation its latest version. In the words of the IAIS, ComFrame is a set of international supervisory requirements focusing on the effective group-wide supervision of IAIGs.

As currently structured, ComFrame consists of three modules, setting forth the criteria for identifying IAIGs to which ComFrame will apply, the supervisory requirements to which IAIGs must comply, and the manner in which supervisors will conduct group supervision, particularly through the use of supervisory colleges. Each module contains several standards (referred to as "Elements" in the ComFrame draft), parameters, and guidelines setting forth the details of how the IAIS believes large internationally active insurance groups and their supervisors should meet the objectives of ComFrame.

ComFrame has been controversial since it was first announced and continues to be so in its current iteration. Many industry observers believe ComFrame will create a new, unnecessary and overly prescriptive layer of regulation. Critics also object to establishing a new set of regulatory standards that apply only to large insurers that transact business globally and that do not apply to equally large insurers which are not internationally active. Many agree, however, that enhancing the coordination of international regulators concerning global groups is an important effort.

The IAIS appears to be undeterred by the criticisms of Comframe, frequently responding by contending that ComFrame is merely a logical extension of the IAIS' insurance core principles to large complex insurance groups.

The current version of the ComFrame "concept paper" was subject to a public consultation period that ended in December 2013. The comments that the IAIS received have now been referred to the IAIS' various subcommittees and working groups which are responsible for deciding whether any changes to the current ComFrame document should be made. In the meantime, ComFrame is being field tested (discussed in more detail below).

The IAIS currently plans to complete ComFrame by 2018, with a series of field testing exercises between now and then, but no additional consultations are planned. Most observers expect that there will be some minor changes to ComFrame by the IAIS over the next few years, but that any strategy to deter its implementation will probably have to be carried out in the individual countries when the IAIS project is completed. Indeed, the question of whether and how ComFrame could be adopted and enforced around the world is an issue that the IAIS has largely side-stepped until now. As ComFrame moves closer to completion at the IAIS, the issue of whether it will become effective in local jurisdictions is likely to grow in importance.

Insurance Capital Standards. Perhaps the most important substantive component of ComFrame is the plan to develop solvency standards for IAIGs. This dovetails with the IAIS' companion initiative to develop a basic capital requirement (BCR) for G-SIIs, which may also apply to all IAIGs. The IAIS ambiguously asserts that the BCR is expected to "inform" the development of insurance capital standards (ICS), which definitely will apply to all IAIGs.

The motivation for this initiative comes from the FSB, which in July 2013 directed the IAIS to develop for G-SIIs "straightforward, backstop capital requirements to apply to all group activities, including non-insurance subsidiaries, to be finalized by the end of 2014."

The IAIS has responded energetically to this direction, adopting a very ambitious time frame for not only achieving this objective, but doing so through two different public consultation periods, sandwiching a field testing period during the Spring of 2014. The IAIS plans to follow the development of the BCR with the establishment of higher loss absorbency (HLA) requirements in 2015 (for G-SIIs), and insurance capital standards in 2016, which the IAIS expects would go into effect in 2019.

Despite this ambitious timetable, there are early indications regarding how difficult it will be to accomplish this mission. An initial consultation document for the BCR that was released in December 2013 provides only a vague explanation of the IAIS' goals. Although it clearly indicates that the IAIS believes a factor-based approach should be used in calculating the BCR, the consultation provides virtually no detail as to what this approach would consist of. The IAIS seems to hope that the details may be established during the first round of ComFrame field testing, mentioned above, but many industry observers are doubtful that goal is realistic. Indeed the first field

testing workshop, held on January 29, 2014, only reinforces the view of many, that the IAIS does not have a sufficiently clear view of what it wants to establish or how to achieve its goals. Moreover, even if that could be achieved, observers argue a second round of field testing would be necessary in order for the accuracy of the selected criteria to be used in a factor-based approach to be tested. It seems highly unlikely that could be completed during 2014.

The implementation of ICS also faces the same challenges discussed above in connection with ComFrame – whether and how it would be adopted and enforced in individual countries, even if the IAIS is able to complete its plans to develop ICS. Like ComFrame, this project may turn out to be more aspirational than meaningful, in terms of its ultimate practical effect on global insurers. For now, however, it rightfully is attracting the attention of most large insurance groups.

G-SII Designation. In mid-2013, the IAIS issued final guidance on (i) the methodology that the FSB would use to identify systemically important global insurers ("*Globally Systemically Important Insurers: Initial Assessment Methodology*") and (ii) the policy measure framework to be applied to such insurers. Immediately afterward, the FSB announced the following initial list of insurance groups as G-SIIs: Allianz SE, American International Group, Inc. (AIG), Assicurazioni Generali S.p.A., Aviva plc., Axa S.A., MetLife, Inc., Ping An Insurance (Group) Company of China, Ltd., Prudential Financial, Inc., and Prudential plc. This G-SII list will be updated each year in November, starting in 2014, and is expected to include at least a few more groups which are predominantly reinsurers.

This announcement immediately sparked controversy for these reasons:

- At the same time the IAIS made its designations, the US FSOC was in the process of designating US non-bank Systemically Important Financial Institutions (SIFIs). But the G-SII list was released before the FSOC SIFI designations were finalized. The US Department of Treasury (Treasury), the FIO, the Securities and Exchange Commission (SEC) and the Federal Reserve have been involved in either the IAIS and FSB process given their leadership and membership roles at the organizations. This raises questions about the influence these members had in making the determinations? Did they endorse the designation of the US G-SIIs, even though FSOC had not yet made a determination on them?
- Many consider the IAIS methodology too bank-centric. Indeed, the IAIS adopted an approach originally used for evaluating systemically important banks. The twenty indicators were categorized in five areas: (i) size, (ii) global activity, (iii) interconnectedness, (iv) substitutability and (v) non-traditional and non-insurance activities, with interconnectedness and non-traditional and non-insurance activities weighted 40 percent and 45 percent, respectively, and the remaining 15 percent split evenly with the remaining three categories.
- Aside from whether the methodology was appropriate, serious questions remain about how the IAIS and the FSB applied the methodology to designate the G-SIIs. Most of the criticism argues that size and global activity should be irrelevant if an insurer is engaged only in traditional insurance activity. The NAIC argued that the G-SIIs should be compared to systemically important banks, because

even the most systemically risky insurer is less risky than the least systemically risky bank.

The IAIS' policy measures were based on work done for the oversight of systemically important banks. The policy measures consist of: (i) enhanced supervision; (ii) effective resolution; and (iii) Higher Loss Absorption (HLA) Capacity. The HLA proposal was the most contentious element of the policy measures. Imposing bank capital standards on G-SIIs feeds into the concerns of many that the IAIS and the FSB are pushing too aggressively for new substantive standards governing the capital of all large globally active insurance groups. As discussed above, in October 2013, the IAIS released a work plan to develop a quantitative capital standard in conjunction with its work on ComFrame.

Assault on Branches. Outside of its work on ComFrame and capital standards, the IAIS has been active in other important areas. The IAIS released its final *Issues Paper on Supervision of Cross-border Operations through Branches* to Members and Observers of the IAIS. The paper stirred controversy in the industry with trade associations arguing that the paper is biased in favor of subsidiaries instead of branches and that the paper suggests that insurance supervisors consider forcing companies into a subsidiary structure. Industry representatives argue that insurers and reinsurers need the flexibility to choose whether to establish a branch, subsidiary, or joint venture for efficiency reasons and to reflect the different and unique marketplaces in which they operate. The paper has provoked little public discussion about next steps, supporting the view many have held that the paper was written at the insistence of just the Japan Financial Services Agency. Nevertheless, other regulators continue to question the use of the branch structure, so activity on this issue may yet be re-energized.

The FSB

The increased activity of the IAIS is, as noted above, due in no small part to the mandates that it has received (and some suggest have sought) from the FSB. The FSB was established by the Group of 20 (G-20) to coordinate global development and implementation of effective regulatory, supervisory and other financial sector policies in response to the 2008 global financial crisis. Members of the FSB include national authorities responsible for the financial stability in significant international financial centers, international financial institutions, sector-specific international groupings of regulators and supervisors and committees of central bank experts. The FSB focused its efforts in 2013 on (i) ensuring cross-border cooperation and information sharing among supervisors, (ii) launching an effective assessment process to evaluate the resolvability (that is, financial restructuring) of global SIFIs, and (iii) developing guidance for resolution.

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The IAIS unveiled its plans for a global insurance capital standard, orICS, in October 2013, explaining it will be included as part of ComFrame. The influence of the FSB in the development of a global ICS fueled concerns in the US that a global ICS is inappropriate for the insurance industry because, again, the concept is too bank-centric, because it is derived from banking regulation and because it has not been updated to take insurance regulation into consideration. The IAIS has faced criticism that the FSB and leaders of the G-20 have pressured the IAIS to develop plans that go beyond the original intent of ComFrame, of which global ICS development is one such example.

Another significant area of concern is that the US representatives are not adequately protecting the interest of the US within the FSB, because they cannot speak for all of the US insurance regulators. The FSB members representing the US (*i.e.*, the Federal Reserve, the SEC and Treasury) have all acquiesced in the FSB activities related to designating the G-SIIs and plans to develop a global ICS. In contrast, the NAIC has expressed frustration with the actions of the FSB throughout 2013, claiming that the FSB is imposing its own bank-centric standards on insurers, intruding on the ComFrame process and forcing, without discussion among the IAIS members, the requirement to develop a global ICS. Noting that neither the NAIC nor any individual state insurance regulator is a member of the FSB, the NAIC has raised concerns about the lack of state regulator representation and lack of transparency at the FSB, even complaining to the President of the United States during a chance emergency meeting on national health care reform in late 2013.

In 2014, the FSB plans to continue working with the IAIS, reviewing its work plan to develop a comprehensive, group-wide supervisory system and by July 2014: (i) establish Crisis Management Groups for the 2013 designated G-SIIs; (ii) the development and implementation of Systemic Risk Management Plans to be completed by G-SIIs; and (iii) decide on designating as G-SIIs as, and determining the appropriate risk mitigating measures for, major reinsurers.

US REGULATORY – FEDERAL DEVELOPMENTS

The federal government has long had a significant role in the regulation of insurance. The SEC, IRS, Department of Justice, Treasury and other agencies have had authority over many aspects of the insurance industry. Indeed, FIO Director Michael McRaith has noted that when FIO has convened inter-governmental agency meetings to discuss insurance issues, as many as 35 agencies and departments show up. The new news is the growing influence of numerous federal entities with regard to core insurance regulatory issues. In this regard, the most prominent players are FIO, the Federal Reserve and FSOC.

The FIO

The FIO Report. On December 12, 2013, FIO issued its long-overdue report to Congress "on how to modernize and improve the system of insurance regulation in the United States," as FIO was obligated to do pursuant to the Dodd-Frank Act.

The FIO report received generally positive reviews, but reactions have varied. It was well written, carefully researched and thoughtfully presented. The report acknowledges many of the strengths and successes of state regulation, but also identifies the areas of needed improvement. It put down some important markers, which may foreshadow greater federal or FIO involvement in insurance regulation. Notably, the report concluded that "the absence of uniformity in the US [state-based] insurance regulatory system creates inefficiencies and burdens for consumers, insurers, and the international community."

The report states that the US insurance regulatory system can be modernized and improved by a combination of steps by the states and some actions by the federal government. It then identifies eighteen "areas

of near term reform for the states," separating its recommendations into issues related to "capital adequacy and safety/soundness" and "reform of insurer resolution practices," as well as nine "areas for direct federal involvement in regulation."

Many recommendations involve matters already addressed by the states or FIO – for example, the development of corporate governance standards (which is part of the NAIC's Solvency Modernization Initiative, as discussed in the Solvency Modernization Initiative section of our Annual Review and Forecast). Other proposals are more controversial – like a recommendation that states should be cautious before adopting principle-based reserving (PBR) or developing a uniform and transparent solvency regime for reinsurance captives (already a simmering debate). Other recommendations seem somewhat unlikely to ever be considered by anyone. Indeed, the recommendation that FIO should "engage in supervisory colleges to monitor financial stability and identify issues or gaps in the regulation of large national and internationally active insurers" was flatly rejected by one prominent state

Critics argue that these "prudential" requirements will more likely hurt the economy and consumers, rather than protect them

insurance financial regulator at the NAIC's Fall National Meeting.

One proposal in the FIO report that may lead to relatively prompt follow up and was almost universally hailed urged Treasury and the US Trade Representative to exercise their authority to pursue "covered agreements" addressing reinsurance collateral.

Now, the question is what, if anything, will come out of the report. Various insurance trade organizations and the NAIC issued supportive comments about the report immediately following its release. Because the report was issued during the NAIC's Fall National Meeting, brief comments about the content and recommendations of the report occurred during many of the committee, task force and working group meetings. The US House Committee on Financial Services Subcommittee on Housing and Insurance held the first congressional hearing on the FIO report on February 4, 2014. The hearing was well attended by Subcommittee members and was primarily focused on testimony by FIO Director Michael McRaith and Commissioner Thomas Leonardi (CT). There was an equal measure of criticism and praise of both FIO and state regulation. Key takeaways from the testimony and statements from the Subcommittee included: (1) alarm at the increased activity by international regulators and the IAIS and the alleged lack of influence by US regulators; (2) sharp criticism of the lack of uniformity and cost of our state-based system of regulation; (3) praise for the effectiveness of our state-based system of regulation, as evidenced by the overall performance of the insurance industry during the financial crisis; and (4) general questions of what the proper role of FIO should be, including questions aimed at the costs and benefits of FIO. There are no signs that Congress plans to take any further action right now.

Other FIO Activity. FIO was active in 2013 outside of finalizing and releasing the FIO Report. FIO has been the driving force within the EU-US regulatory dialogue. FIO is also deeply involved at the IAIS. Director McRaith is a member of the Executive Committee and is the Chairman of the important IAIS Technical Committee, which oversees the development of ComFrame, insurance capital standards, and many other IAIS policy initiatives.

FSOC Non-bank SIFI Designations – the Process and the Conflicts

The US FSOC was established under the Dodd-Frank Act. Among other powers, it is authorized to designate non-bank institutions as systemically important financial institutions, or SIFIs. The FSOC consists of 10 voting and 5 nonvoting members, which includes the expertise of federal financial regulators, state regulators and an independent insurance expert appointed by the President of the United States.

The FSOC designated three US insurance companies (Prudential, GE Capital and AIG) as SIFIs in 2013, and is rumored to be considering two more insurance companies as we publish.

As a SIFI, a non-bank financial company will be subject to consolidated supervision by the Federal Reserve and enhanced prudential standards, including both (1) "enhanced prudential standards" of the type applied to bank holding companies with consolidated assets of US$50 billion and up; and (2) the requirement to develop a "living will" (a pre-crisis insolvency and liquidation plan). These requirements are imposed under sections 165 and 166 of the Dodd-Frank Act.

The insurance industry responded to initial designations by arguing that insurers (including AIG's insurance business) were not the cause of the financial crisis; that regulators do not understand the difference between banks and insurance; that the "Collins Amendment" (§171 of the Dodd-Frank Act) imposes capital requirements that are inappropriate for non-bank institutions; and that the designation of insurer SIFIs is not only going to be costly and disruptive, but would virtually guarantee that the designated insurers would have to reduce their insurance offerings, raise the cost of their products, and generally become less competitive. Critics argue that these "prudential" requirements will more likely hurt the economy and consumers, rather than protect them.

The SIFI designations (along with the other federal oversight that designation brings) has increased the level of confrontation between state and federal insurance regulators. Insurance experts on FSOC, including a state regulator, charged that their federal colleagues just do not understand the insurance industry. The NAIC sees itself being edged out of decisive roles. Meantime, many federal regulators, who want a consolidated approach to insurance groups, showed little patience with what they considered to be the piecemeal approach of state regulation. As this scenario plays out, we are likely to see a higher level of federal-state confrontation, along with increased regulatory costs for the industry as enhanced regulation increases, until this dual and uncoordinated approach gets resolved.

Initial SIFI Designations. As noted above, on July 18, 2013, the IAIS published its methodology to identify global-systemically important insurers, or G-SIIs, and the Basel-based FSB designated nine global insurers as G-SIIs, including three American companies: AIG, MetLife, and Prudential. The FSB's press release stated that the designation had been done "in consultation with the IAIS and national authorities."

From the US side, the "national authorities" included at least Treasury, the Federal Reserve, the SEC, and the FIO. As a result, the FSB's declaration seemed to suggest that US federal regulators helped designate the three American companies on an international level, while the US designation procedures were still taking place. Critics have argued that, in this respect, the distinction between international and national SIFI regulation is becoming unclear; that the FSOC designations themselves have been frustratingly opaque; and some have even questioned whether FSOC understands the basics of insurance economics.

On June 8, FSOC voted to designate Prudential, GE Capital and AIG as non-bank SIFIs. This subjects them to consolidated supervision by the Federal Reserve and to enhanced prudential standards, including the same increased minimum capital levels required of qualifying banks. The consolidated supervision aspect obviously pitted the Federal Reserve against the NAIC, which continues to advocate regulation based on state-based domicile of individual operating companies. (MetLife was already under the Federal Reserve's supervision because it had been designated as a bank holding company. The Federal Reserve approved its deregistration with the sale of its bank to GE Capital in February 2013. But it still faces the possibility of re-designation as a non-bank SIFI.)

Responses to SIFI Designations. AIG and GE Capital accepted their designations with apparent enthusiasm. AIG said that it "welcomes supervision by the Federal Reserve," and both companies confidently stated they could meet the enhanced Federal Reserve standards. That left Prudential, the third, which very strongly opposed the designation.

The Prudential Designation. Prudential asked for a formal hearing regarding its designation, but lost as FSOC voted, 7-2, to designate Prudential as a non-bank SIFI. FSOC's 12-page public decision cited Prudential's "interconnectedness" with US and global financial institutions of all types, as well as the potential for a "run" on Prudential's life insurance policies, and concluded that a lack of liquidity of Prudential's assets to meet this demand could disrupt markets. It also added that even if a run could be stayed, it would still undermine consumer confidence, and still produce a major impact on Prudential's presence in the annuity, retirement, asset management, and commercial mortgage servicing markets. In another slap to state regulators, FSOC acknowledged their existence but concluded that the collective force of state regulation still falls short of the powers available under Dodd-Frank — especially the element of "consolidated, enterprise-wide supervision."

There were three dissents. Roy Woodall, the FSOC "independent member with insurance expertise," and the only insurance member with an FSOC vote, criticized the decision for failing to support its conclusions. "I do not agree, without further supporting analysis, that relatively small exposures spread among many financial institutions would materially impair these same institutions simply because of broader market effects." His conclusion was that FSOC had given too much credence to "improbable and extreme failures without considering other factors."

Edward DeMarco, acting director of the Federal Housing Finance Agency, gave a qualified dissent "at this time." His position was that, while Prudential could, under some circumstances, pose a threat to financial stability, he thought there were "mitigants" and alternatives to consider, as well as the economic cost of the SIFI designation.

Missouri Insurance Director John Huff, one of five non-voting FSOC members, had already publicly criticized FSOC's approach, arguing that "some of my fellow

FSOC members may not understand the insurance industry." His dissent repeated that theme.

Prudential had 30 days to appeal to a US district court. (In contrast, there is no appeal from an FSB designation.) Prudential later elected not to appeal the FSOC's decision further. Nonetheless, the decision making process and the decision to include Prudential as a non-bank SIFI has continued to stimulate debate in political and regulatory circles.

Other Developments: MetLife and Berkshire Hathaway. Turning back to the third US company on IAIS' list, MetLife announced on July 18, 2013, that FSOC had informed the company that it had now reached "stage 3"of the SIFI designation process. MetLife's president called this "a case of mistaken identity," declaring "[n]ot only does exposure to MetLife not threaten the financial system, but I cannot think of a single firm that would be threatened by its exposure to MetLife. … The life insurance industry is a source of financial stability. Even during periods of financial stress, the long-term nature of our liabilities insulates us against bank-like 'runs' and the need to sell off assets."

To complete the picture, MetLife, the third US-based G-SII, is in the final stage of an FSOC review, as of the date of this publication. And in January 2014, FSOC began to consider whether Berkshire Hathaway should be added to the list. These steps will continue to keep the issues of the systemic relevance of insurers at the center of policy debates.

The Impact of a SIFI Designation. Section 165(a)(2)(A) of the Dodd-Frank Act allows the Federal Reserve to "tailor" the prudential standards for non-bank SIFIs, either on a company-by-company basis, or by category. But the capital requirements of §171 of the Dodd-Frank Act, the so-called "Collins Amendment," seem to hamstring that provision. Section 171 requires the federal banking agencies to set minimum leverage and RBC requirements that cannot be "quantitatively lower" than those required for insured depository institutions. Michael S. Gibson, Director of the Banking Supervision and Regulation division of the Federal Reserve, noted a "bit of a challenge there to make sense of those two dissonant provisions in Dodd-Frank."

In July 2013, the Federal Reserve issued its final rule on capital requirements for banking institutions, implementing the Basel III capital reforms. It provided a temporary exemption for Savings and Loan Holding Companies (SLHCs) that are either insurance companies themselves or that held more than 25 percent of their total consolidated assets in underwriting subsidiaries. But it also said it would develop separate capital requirements for these exempted SLHCs by 2015. Some insurance industry leaders hailed this as a victory and an acknowledgement by the Federal Reserve that insurers must be judged by "non-bank-centric" standards. But other insurance groups continued to push for Dodd-Frank reform.

Aside from "prudential" operating standards, non-bank SIFIs must create a "living will." This consists of two elements: (1) a "recovery plan," designed to prevent a company from failing if it meets financial distress, and (2) a "resolution plan," designed to minimize the impact of the company's failure. The requirements include creating an independent enterprise risk management plan and being subject to annual "stress tests" conducted by the Federal Reserve.

The public versions of the resolution plans, available on the Federal Reserve's website, are not especially revealing. One plan provides a three-step," three-sentence resolution summary: "Strategy 1: Sale … as a going concern to a third party; Strategy 2: Recapitalization ... pursuant to one or more Chapter 11 plans of reorganization; and Strategy 3: Orderly wind-down through multiple sales of … assets and/or portfolios."

The bottom line is that designated companies will find their operations restricted. Some existing activities may need to be terminated and some products may be discontinued. Insurers may also need to dispose of some assets; have their potential for expansion limited; find their freedom to merge constrained (subject to overall consolidated liability tests); and will need to pay their share of the roughly US$700 million annually due to the Office of Financial Research.

From a competitive viewpoint, the non-bank SIFI designation is restricted to a few companies. Their competitors will not be subject to any of these financial liabilities or operating restrictions. This likely will impact competition, but no agency has yet discussed the value of this lost competition, and how it could be mitigated.

The Chamber of Commerce Report. After Prudential's designation, there were increased industry calls for modifications to the SIFI designation process and its consequences. One industry member called the actions of the IAIS and FSB a "major intrusion" into US insurance regulation, arguing that their global standards are too "bank-centric."

In December 2013, the US Chamber of Commerce published a withering attack, entitled "Financial Stability Oversight Council Reform Agenda." It concluded that "[i]n the over three years since FSOC's creation, we believe several fundamental shortcomings in the FSOC's structure and operations have been exposed."

Among other things, it proposes that any vote on SIFI designation require assent by three-quarters of the FSOC (not two-thirds), and that if the primary regulatory or council member with expertise does not vote in favor, then the decision must be deferred until a second vote 45 days later. It also argues that a non-bank SIFI's prudential regulator should be the company's primary regulator.

The Chamber of Commerce also proffered advice. For non-bank SIFI designations, it called for a "reform" of the designation process, including: (1) FSOC should not make non-bank designations until all systemic risk rules conform to the limits on FSOC's powers; (2) there should be "due process" in designations, including notice of the supposed systemic risk behaviors so that companies can voluntarily restrict or limit those activities to avoid SIFI designation; (3) there should be explanations of exactly how FSOC applies the five metrics; (4) "bank-centric" regulations should be abandoned in favor of rules tailored to specific industries; and (5) a path should be established to reverse SIFI designation.

A Glimmering of Hope for Change. While the chances for the Chamber of Commerce's "reform agenda" are extremely unlikely, there are signs that the federal agencies are increasing aware that insurance institutions cannot be regulated in the same way as banks. The catch here is that the Federal Reserve isconstrained by current legislation.

During her confirmation hearings on November 14, 2013, Janet Yellen, now Chair of the Federal Reserve, told lawmakers that she believed that large, systemically important insurance companies should not face the same capital rules as banks. Yellen said:

One industry member called the actions of the IAIS and FSB a "major intrusion" into US insurance regulation, arguing that their global standards are too "bank-centric"

"I do believe that one-size-fits-all should not be the model for regulation and that we need to develop appropriate models for regulation and supervision of different kinds of institutions. Insurance certainly has some very unique features that make them very different from banks. And we're taking the time to try to study what the best way is to craft regulations that would be appropriate for those organizations."

But Yellen also made it clear that Dodd-Frank "constrains the scope of the Board's discretion" and requires that capital requirements for insurers "shall not be less than" those for banks with federal deposit insurance."

The following day, Sarah Bloom Raskin, President Obama's nominee for deputy US Treasury Secretary, told the Senate Finance Committee that a "one-size-fits-all approach is not going to work here." She went on to say that "[i]nsurance companies have a very different set of asset-liability structures than do banks. And to regulate them in terms of a one-size-fits-all approach is not going to be an effective form of supervision or regulation in my experience."

The implication is that changes, that can offer some meaningful relief to insurer SIFIs, will require a statutory re-working of Dodd-Frank. However, any efforts to tailor its requirements for insurers are sure to be met with demands for many other changes from many other sources. It remains to be seen how this will develop, and we will report on any movements as they occur.

Other Federal Legislative and Regulatory Developments

TRIA – pending expiration and impact on the P&C Market . Federal legislation to continue some form of federal backstop for terrorism reinsurance remains stalled in the US House of Representatives, despite a rash of hearings in Fall 2013. The hearings focused on the ability of the private market to take on more terrorism risk and the possible impact if TRIA were to expire. Most analysts expect that some form of backstop will be re-enacted, but with different TRIA triggers, higher deductibles and more aggressive recoupment provisions. The first major indicator of what direction the backstop is likely to take will be the mark-up of pending legislation by the House Financial Services Committee, which the industry hopes will be issued in the first quarter of 2014.

Affordable Care Act Implementation. Many thought that the US Supreme Court decision upholding the Patient Protection and Affordable Care Act's (ACA) individual mandate and the re-election of President Barack Obama in 2013 would remove all doubt that the ACA is and would remain the law of the land. Federal activity in late 2013, however, proved that not only is that question not settled, but also that essential rules and requirements relevant to insurance companies offering health plans on and off of the exchanges may change at a moment's notice.

Legislative reaction to exchange enrollment problems. On October 1, while the government was shut down, the state and federal exchanges opened for enrollment. Many customers encountered serious or even crippling problems when they tried to sign up for coverage on the federal exchange. The technical failure of the federal exchange became notorious and took almost two months to fix. The political fallout, however, from the technical failures persists with Congress pressing federal agency and contractors for information about the failures and legislative proposals related to the open enrollment period, delaying the individual mandate and data security.

Political Impact on the Individual Market coverage issues. The politics of ACA implementation could not have been worse, as members of Congress highlighted constituents' reports that they had received cancellation notices from their insurance carriers. In response to the Congressional pressure, HHS issued guidance "establish[ing] an additional hardship exemption," allowing those who enroll in coverage during the open enrollment period to avoid the individual mandate penalty – even if coverage is not effective until after March 31. The American Academy of Actuaries warned that delaying the individual mandate and/or extending the open enrollment period "could have negative consequences for health insurance coverage and costs. Finally, on the issue of plan cancellations, President Obama announced a "transitional policy" designed to help individuals whose plans have been canceled as of January 2014 because they do not meet the ACA's requirements. The policy allows insurers to renew otherwise noncompliant plans in the individual or small group markets for one year. Although HHS "encouraged" state insurance agencies to adopt the transitional policy, a number have declined to do so. On December 19, Secretary Sebelius announced that consumers whose insurance policies have been cancelled and who cannot afford coverage on the exchange will be eligible for a hardship exemption from the individual mandate and will be allowed to purchase a catastrophic plan. The announcement followed a letter signed by six Democratic and Independent Senators suggesting the policy change. These last minute federal rule changes and sparse compliance by the states have undoubtedly changed the economic model for health insurers and health plans and will certainly affect the ability of health insurers and health plans to accurately model for 2014.

Further Dodd-Frank Implementation. The NAIC and industry executives have touted the fact that very few insurers failed during the "Great Recession." Company executives complain that despite this record of success, both state and federal regulators are requiring insurers to submit to extensive and increased regulation. Company failure (and its prevention) is a frequent cause of regulation, but now just the spectre of a large failure is prompting very significant reforms.

Resolution Authority and State Receivership Law. An insurance company that is a "covered financial company" (CFC) under Dodd-Frank Act §5381 is subject to the receivership (or resolution) related provisions that are unique in several ways:

- The CFC may be required to determine how its assets would be administered in a receivership – even if the company is nowhere close to insolvency – and to develop a resolution plan or "living will" subject to applicable regulatory approval
- The receiver of a financially troubled CFC may be either the Federal Deposition Insurance Corporation (appointed under Dodd-Frank Act) or the domiciliary insurance regulator (appointed under state law) and
- The receivership may be commenced in either state or federal court after (a) the US Treasury Secretary determines that the insurer is a CFC and either (i)

the CFC's board acquiesces or consents to appointment of a receiver, (ii) the Secretary petitions a US district court, or (iii) the domiciliary regulator files a petition in state court. If the court does not grant the petition within 24 hours, it is deemed granted "by operation of law," and an appeal therefrom does not stay or enjoin the order.

So far, no insurer has been subject to these proceedings, but preparations for such an event moved forward in a number of significant respects.

Following a new chapter in the NAIC's *Handbook for Insurance Company Insolvencies*, dedicated to state implementation of a Dodd-Frank Act receivership, Illinois and other states passed laws to enable the swift entry of a rehabilitation or liquidation order against a putative CFC.

Seeking to overcome the lack of uniformity in state resolution law, the FIO Report recommends that states (through the NAIC): (i) adopt a uniform approach to address the closing out and netting of qualified contracts between counterparties; (ii) build on the NAIC's Global Receivership Information Database and develop requirements for transparent financial reporting, not including a single accounting standard, and (iii) adopt and implement uniform guaranty fund protection, regardless of the policyholder's residence. FIO also suggests that the National Conference of Insurance Guaranty Funds and National Organization of Life Health Guaranty Associations model the potential adverse impacts on the guaranty fund system, and how the system would fare, in the event of a failure of a large insurance group in the US.

For the last decade, the most significant developments in insurer resolution have involved rehabilitation, the most adaptable form of receivership. One of the most important court decisions in 2013 concerned the rehabilitation of a financial guaranty insurer. *In re the Rehabilitation of Segregated Account of Ambac Assurance Corp.* (WI Ct. of App. Oct. 24, 2013) upheld a plan for the rehabilitation of a segregated account. In its report, FIO notes that one of the ways states protect policyholders is to ring-fence assets with these accounts. The *Ambac* opinion highlights FIO's observations about the great discretion afforded an insurance commissioner to fashion a rehabilitation plan and overcome numerous constitutional and other challenges. Resolution scholars will now await a decision by the state's supreme court.

Private Mortgage Guaranty Insurance. Regulation of the private mortgage insurance industry remains in flux at year end, as federal and state authorities continue to debate separate reform efforts. Private mortgage insurers are regulated directly by state departments of insurance and indirectly through the standards imposed by the government sponsored enterprises (GSEs) (and the Federal Housing Finance Agency (FHFA) as the conservator of the GSEs). The CFPB also affects private mortgage insurance through regulation of insured lenders.

The NAIC has proposed significant changes to its model mortgage guaranty insurance act, including altering capital, surplus and reserving obligations. At the same time, the FHFA and the GSEs revised their private mortgage insurance master policy requirements and are poised to announce revisions to the PMI eligibility criteria (also including capital, surplus and reserving obligations). Unfortunately, there has been little coordination between state and federal regulators.

The status of regulation is also complicated by uncertainty both on Congress's ultimate direction for the GSEs and the FHFA, and whether the federal government will directly regulate PMI issuers. In the meantime, Treasury has signaled its desire to become the primary regulator for private mortgage insurance. FIO recommended in its modernization report that the development and oversight of mortgage insurance standards should be federally regulated because PMI plays a key role in the federal housing finance system.

US REGULATORY – NAIC AND STATES

Not all activity occurs within federal or international institutions. As always, the NAIC and individual states have been active over the past year. It certainly is true that many of the NAIC's initiatives are either a response to or a part of international developments, but the NAIC and state regulators lack no motivation or desire to continue to improve and enhance US insurance regulation. Over the last 12 months, we have seen activity in these areas:

Reinsurance

Reinsurance regulatory reform has been an active area for more than a decade. 2014 saw important advancements, particularly on reinsurance collateral reform.

Status of Adoption of the Model Laws. The NAIC revised the Credit for Reinsurance Model Law and Regulation to allow the reduction of collateral required to be posted by unauthorized assuming reinsurers that meet certain certification requirements. Eighteen states adopted revisions to their credit for reinsurance statutes and/or regulations: Alabama, California, Connecticut, Delaware, Florida, Georgia, Iowa, Indiana, Louisiana, Maine, Maryland, Missouri, New Hampshire, New Jersey, New York, Pennsylvania, Rhode Island and Virginia. These states represent about 53 percent of the primary insurance premium written in the US. Five more states will reportedly adopt the revised Model Law or Regulation in 2014. That would bring the total representation of primary insurance premium written in the US to 75 percent.

Qualified Jurisdiction (E) Working Group. Reduced reinsurance collateral requirements apply only to certified reinsurers that are licensed and domiciled in a

Reinsurance regulatory reform has been an active area for more than a decade. 2014 saw important advancements, particularly on reinsurance collateral reform

"qualified jurisdiction." While the designation of qualified jurisdictions is left to the individual states, the Model Law and Regulation provide for the NAIC to create and maintain a list of Qualified Jurisdictions. Individual states must take this NAIC list into account when designating a qualified jurisdiction.

The NAIC moved unusually swiftly in 2013 and conditionally designated four qualified jurisdictions under a special expedited review process – Bermuda, Germany, Switzerland and the United Kingdom. The NAIC went from (i) developing the methods and processes needed to create the list (adopting its paper, *Process for Developing and Maintaining the NAIC List of Qualified Jurisdictions*) to (ii) creating a new Qualified Jurisdiction Working Group tasked to maintain the list, to (iii) approval of four jurisdictions – all by the Fall National Meeting.

More jurisdictions may be qualified through the Working Group and by individual states using either the methodology in the paper or the expedited conditional qualification process. Either way, the jurisdiction will undergo a comparison of its reinsurance supervisory systems to the financial solvency regulation under the NAIC Accreditation Program, adherence to international supervisory standards and relevant international guidance for recognition of reinsurance supervision. Priority will be given to requests from states and foreign jurisdictions specifically requesting an NAIC evaluation. A jurisdiction may be conditionally designated as qualified under the expedited process, effective for one year and subject to extension.

Reinsurance Financial Analysis (E) Working Group. The Reinsurance Financial Analysis Working Group (RE-FAWG) was formed to establish a peer review process to allow "passporting," a process by which a reinsurer's certification by one state would allow other states to certify that reinsurer without undergoing a separate review and approval process. The working group's primary focus for 2013 was reviewing 29 reinsurers approved by Connecticut, Florida and New York as certified and eligible for collateral reductions.

By December 31, 2013, RE-FAWG completed its peer review and gave "passport" status to 21 of the 29 reinsurers.

For 2014, RE-FAWG stated that it will focus on: (1) new applications for review by the working group; (2) developing a standard application form; (3) developing procedures to analyze financial conditions of reinsurers that, moving forward, will qualify for the passporting; and (4) renewing certifications.

The work of the Qualified Jurisdiction Working Group and RE-FAWG are remarkable and commendable examples of state regulators, via the NAIC, acting in concert. Of course, it remains to be seen whether other states will adopt and implement the decisions of these two groups. If they do not, it will provide further support for FIO's assertion that state regulation lacks critical uniformity. Especially in light of the criticism of the state-based regulation of insurance, the NAIC proved it could move quickly on matters of importance to the industry.

Captives and Special Purpose Vehicles (SPVs)

The NAIC Officially Evaluates Captive and SPV Transactions. During 2013, the NAIC continued its evaluation of how life insurers use special purpose financial captives ("financial captives") in connection with reserving for term life insurance and universal life insurance with secondary guarantees, as required by Regulation XXX and AXXX. Despite a moratorium on the use of financial captive transactions by New York, the year ended with the evaluation of the use of financial captives expanding into other issues that one prominent regulator contended are controlled by the NAIC's accreditation program.

The year began quietly enough with the June completion of the NAIC white paper on captives and special purpose vehicles. Some industry observers were initially concerned when the NAIC began working on that white paper in 2012. They feared the paper would severely criticize the use of financial captives and SPVs, but the paper did no such thing. Instead, it proposed several relatively benign recommendations for greater transparency and accounting procedures related to financial captives and SPVs. In the summer, these recommendations were assigned to various NAIC task forces and working groups, including, most prominently, the Principle-Based Reserving (PBR) Implementation (EX) Task Force, chaired by Superintendent Joseph Torti III (RI), one of the most outspoken critics of the use of financial captives and SPVs. The Task Force was asked to consider the white paper's recommendations in the context of the proposed PBR system and make further recommendations, if any, to the NAIC's Executive Committee.

Public attention on the use of financial captives re-emerged in September, with the publication of a report by Rector & Associates, Inc., which the PBR Implementation Task Force had retained to assist it in carrying out this charge. The Rector Report was the focus of a heated discussion during the NAIC's Fall National Meeting about the use and regulation of captives and SPVs.

Three tentative positions emerged from that discussion. First, there was a clear consensus among Task Force members that transactions to address XXX and AXXX reserves should be allowed to continue. Second, these transactions should be allowed to continue, but only if they comply with some yet-to-be determined criteria. These might include having reserves set using a uniform actuarial standard (but not XXX and AXXX), having uniformity in primary and other assets, and increasing disclosure. Third, most regulators agreed (with Superintendent Torti being the most adamant) that once PBR is implemented, these kinds of transactions should stop and no new business should be added to open-ended transactions.

This discussion left many observers wondering how the NAIC could achieve these objectives. In the first place, it is unclear whether a uniform actuarial standard could be developed. Mr. Rector stated it might be difficult to decide what is too conservative or not conservative enough. Some regulators claimed that the Valuation Manual life reserve standards, or VM-20, being developed for use in PBR, could be used even before PBR is actually adopted. As discussed in the PBR Implementation section of our Annual Review and Forecast, VM-20 needs more work. It is also unclear what types of assets would qualify as primary versus other assets. To address these and other concerns Superintendent Torti stated he would work with Task Force's Co-Chair, Commissioner Julie Mix McPeak (TN), to discuss the creation of a technical group to run parallel with Rector & Associates, Inc.'s work.

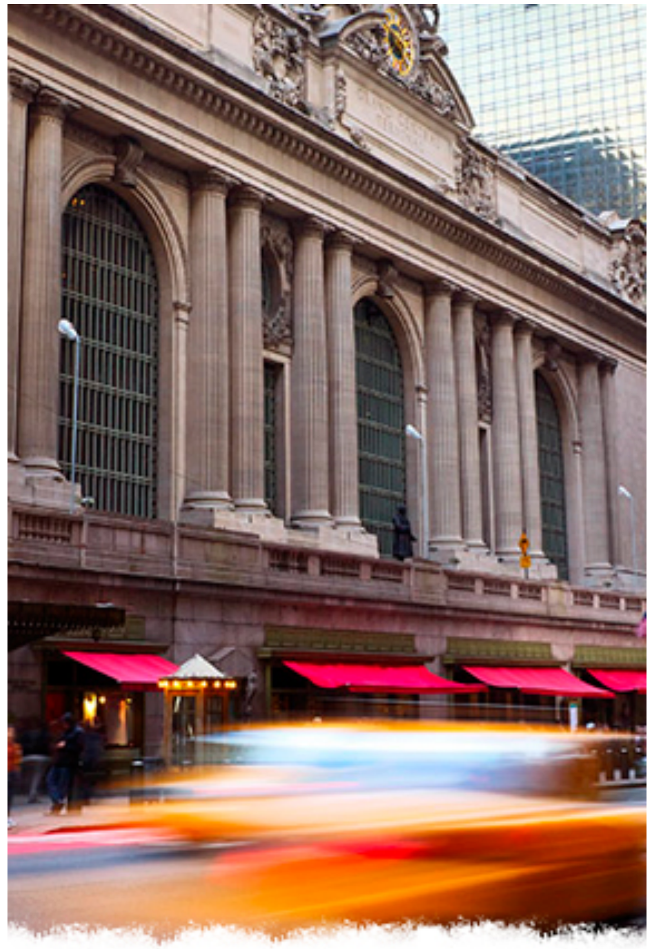
If that were not enough, Superintendent Torti sent a memo dated December 2, 2013 to John Huff, Chair of the NAIC's Financial Regulation Standards and Accreditation Committee. He stated his belief that captives and SPVs that are used in XXX and AXXX transactions are "multi-state insurers" for accreditation purposes. If this were the case, the flexibility many states employ for the financial regulation of financial captives and SPVs would be severely reduced. Several Committee members agreed that the intent of the term "multi-state insurer" needs to be clarified regarding which companies are included in the scope of the accreditation standards. The Committee directed NAIC staff to draft proposed revisions that will clarify the definition of "multi-state insurer" for review at the 2014 Spring National Meeting.

Thus, the work during 2013 to implement the NAIC's white paper – and the Rector Report – seems to be just heating up. The ongoing discussions of these issues during 2014 could have a significant impact on how life insurers manage the reserves for their term life and universal life with secondary guarantees policies.

State Actions Regarding Captive and SPV Transactions. In June, the New York Department of Financial Services (NYDFS) surprised the industry by issuing a report criticizing and calling for a national moratorium on captive and SPV insurance transactions. The NYDFS referred to such transactions as "shadow insurance" after an investigation into the captive insurance programs of New York-based life insurers and their affiliates. The NYDFS argued that these captive insurance transactions were used to artificially lower reserve and collateral requirements and recommended that state commissioners and federal agencies conduct investigations into the use and disclosures of captive programs. The NYDFS report was largely ignored by insurance regulators at the Summer National Meeting.

By the end of the year, the NYDFS implemented one of its recommendations regarding captive and SPV transactions by requiring New York-domiciled and licensed insurers to disclose captive and affiliated offshore reinsurance transactions in the 2013 New York Supplement to the Annual Statement blank's new Exhibit on Captive Reinsurance Transactions.

Other states formalized their rules and expectations regarding captive and SPV transactions. For example, in January 2014, Vermont issued a bulletin on SPVs in response to the activities at the NAIC. The bulletin documents and validates existing practices at the Vermont Department of Financial Regulation, but also signals that there will be heightened transparency with other regulators with respect to confidential information regarding captives and captive transactions.



Despite the continuing regulatory attention to captive transactions, 2013 was extremely active from a transactional perspective, with transactional momentum continuing into a busy 2014, as discussed in the Commercial and Transactional Issues and Trends section of our Annual Review and Forecast.

Principle-Based Reserving (PBR) Implementation

2013 saw more movement toward the adoption of principle-based reserving for life insurers, but progress continues to be very slow. In some cases, work that many thought had been finished was re-opened to address new concerns.

Most industry observers believe that even after PBR is adopted, life insurance reserves will be redundant due to the conservatism in the version of PBR that the NAIC developed. As a result, the need for captives and SPVs will likely continue to exist

At least four issues continue to present problems for PBR implementation. First, concerns exist that regulators are not adequately trained to review how insurers will conduct PBR once it is in effect. Second, several items in the Valuation Manual, which contains the detailed instructions for insurers on how to conduct PBR, need to be adjusted or revised. Third, the challenges for smaller companies to use PBR are receiving heightened attention and various proposals are under consideration, such as allowing for a longer transition period for small companies with a small premium volume. Fourth, the details of how to collect data for regulators to evaluate insurers' PBR approaches are yet to be determined.

PBR continues to face political challenges as well. As of year-end, only seven states, representing less than 8 percent of US life insurance premiums, have adopted the amendments to the standard valuation law and standard non-forfeiture law that are needed to authorize the use of PBR. At least forty-two states, representing at least 75 percent of premium, must enact these amendments in order for PBR to become effective anywhere. Moreover, the industry's enthusiasm to push for PBR adoption may be significantly reduced, given the consensus view of regulators that once PBR is adopted, no new XXX and AXXX captives should be allowed, as discussed in the Captive and Special Purpose Vehicles (SPV) section of our Annual Review and Forecast. Most industry observers believe that even after PBR is adopted, life insurance reserves will be redundant due to the conservatism in the version of PBR that the NAIC developed. As a result, the need for captives and SPVs will likely continue to exist even after PBR is adopted.

Finally, perhaps the biggest political unknown for proponents of PBR is the potential effect of the FIO report on the modernization of insurance regulation in the United States, discussed in more detail in the FIO section of our Annual Review and Forecast. The FIO report recommends that "states should move cautiously with the implementation of principle-based reserving." This could have a severely chilling effect on the willingness of state legislatures to adopt the new laws that are needed to allow PBR.

Clearly, there are no signs that the NAIC's enthusiasm and commitment to adopting PBR is waning, but as this project now approaches its ten-year mark, and as new challenges to its development continue to emerge, the NAIC's goal to have PBR in place by 2018 seems to be increasingly unlikely.

Private Equity and Hedge Fund Insurance Activity Regulation

In 2013, several influential regulators expressed concerns over private equity and hedge funds investing in insurance companies, specifically purchasing large fixed annuity businesses. The trend raised concerns because regulators viewed such firms as typically having a shorter-term oriented business model than traditional insurers, and the annuity business is specifically focused on ensuring long-term security for policyholders.

In the spring of 2013, NYDFS subpoenaed several private equity firms with interests in buying fixed annuity companies or businesses. NYDFS was concerned about the rapid growth of private equity firms in the fixed annuity market and the perceived short-term focus of private equity firms. Reportedly, the subpoenas were a precursor to NYDFS development of enhanced regulations that may take direction from New York's regulations on private equity acquisition of banks. Superintendent Lawsky has described such enhanced regulations as designed, in part, to encourage a long-term outlook on the industry.

In mid-2013, the NAIC Financial Analysis Working Group (FAWG) released a memorandum outlining best practices and new procedures to address the market trend. Such best practices included: (i) factors to take into consideration when reviewing Form A filings; (ii) potentially changing the Credit for Reinsurance Model Law to give regulators additional authority to require approval of transactions with non-affiliates; and (iii) changing state investment laws to provide regulators more authority to limit risks.

NYDFS had already taken its own steps to implement some of the recommended enhanced Form A review factors. On July 31, New York announced that

Guggenheim Partners LLC had agreed to "a set of heightened policyholder protections" as part of its planned acquisition of Sun Life Insurance and Annuity Company of New York (Sun Life). According to the NYDFS, "these policyholder protections include heightened capital standards; the establishment of a separate, additional 'backstop' trust account dedicated to further safeguarding policyholder claims; enhanced regulatory scrutiny of investments, operations, dividends, and reinsurance; and other strengthened disclosure and transparency requirements." Guggenheim will maintain Sun Life RBC Levels at an amount not less than 450 percent and will establish a separate US$250 million backstop trust account, held separately for at least seven years and dedicated exclusively for the protection of policyholders. This backstop is extremely large for a company with a 2012 capital and surplus of approximately US$349 million. Almost one month later, NYDFS imposed similar "policyholder protections" on Apollo Global Management LLC when its affiliate acquired Aviva Life and Annuity Company of New York.

Given the publicity surrounding this issue, and NYDFS's requirements in its Form A approvals, this is likely to be the new normal for private equity and hedge fund parties seeking to acquire life insurers in 2014.

Solvency Modernization Initiative Update

The NAIC's Solvency Modernization Initiative (SMI) has focused on five key areas: (i) capital requirements, (ii) international accounting, (iii) insurance valuation, (iv) reinsurance, and (v) group supervision. The NAIC was busy in 2013, achieving more SMI milestones, including moving the Model Holding Company Act and Own Risk Solvency Assessment Model Acts and Regulations towards NAIC accreditation status by Jan. 1, 2016. The Solvency Modernization Initiative (E) Task Force officially disbanded at the end of 2013 because their official charges were met.

Model Holding Company Act and Own Risk Solvency Assessment Update. Over the last few years, the Group Solvency Issues (E) Working Group was developing the Risk Management and Own Risk Solvency Assessment Model Act (#505) (ORSA); the Insurance Holding Company System Regulatory Act (#440) (HCA Model Act); and the Insurance Holding Company System Model Regulation (#450) (HCA Model Regulation). These are all also tentative accreditation standards, effective Jan. 1, 2016 (provided they are adopted in the requisite number of states). The ORSA was released for a year-long comment period starting January 1, 2014. As of year-end, seven states have adopted the ORSA Model Act and 24 states have adopted the HCA Model Act (of those, seven states have adopted the correlated HCA Model Regulation). Throughout 2013, regulators raised concerns about the lack of uniformity among the states as they adopted the HCA Models. Only Pennsylvania and Delaware required US supervisors to be included in the Supervisory Colleges for foreign groups, as in the HCA Models. Some states' HCAs weaken the confidentiality provisions of the Model HCA.

Additional SMI Activities in 2013 include:

- **Adoption of SMI White Paper**. The SMI Task Force white paper, *The US National State-Based System of Insurance Financial Regulation and the Solvency Modernization Initiative*, was adopted by the NAIC at the Fall National Meeting. The white paper explained and defended the US solvency framework, highlighting the strengths of the national state-based regulatory system and the improvements made after 2008 through SMI.
- **Corporate Governance Updates**. The Corporate Governance (E) Working Group (CGWG) adopted the paper entitled *Proposed Response to a Comparative Analysis of Existing US Corporate Governance Requirements.* It concluded that the US system of ensuring corporate governance practice of insurers is largely effective and robust, but there are several areas where improvements may be made. The areas include: regulatory reporting, disclosure and transparency; off-site monitoring and analysis; on-site risk-focused examinations; reserves, capital adequacy and solvency; regulatory control of significant, broad-based risk-related transactions/activities; preventive and corrective measures, including enforcement; and exiting the market and receivership. To the CGWG, these steps are reasonably necessary to achieve consistency with international standards and meet regulatory needs. The CGWG is now drafting the Corporate Governance Annual Filing Model Act and the *Corporate Governance Annual Filing Manual*, which was exposed for public comment in January 2014.

- **Amendment to the Model Audit Review Act**. The CGWG worked on their draft revisions to the Annual Financial Reporting Model Regulations. These revisions incorporate a new section for internal audit function requirements. By the end of the year, the CGWG included confidentiality provisions, but rejected proposals to exempt the entities that are compliant with the Sarbanes-Oxley Act of 2002 (SOX) from the internal audit function requirements. They concluded that confidentiality is not an issue because the disclosure will be filed with state insurance regulators; and that SOX does not require an internal audit, so there is no reason to exempt SOX-compliant entities.

INTERNATIONAL REGULATORY – EUROPE

Solvency II Update

The process leading to implementation of Solvency II has been struck by numerous delays. These delays have resulted in the national implementation deadline being revised to January 31, 2015 for Solvency II rules to be transposed into national law, and final market compliance now January 1, 2016.

Following the trilogue agreement of Omnibus II in November 2013, the European Commission will move forward with the Level 2 measures. Level 2 seeks to work further on areas specified in Level 1 as being the subject of delegated or implementing acts, in relation to which the European Commission in conjunction with the European Insurance and Occupational Pensions Authority (EIOPA) must develop further guidance. This guidance will take the form of binding measures and will bring additional operational detail to the functioning of the Solvency II Directive in practice. As a form of regulation, the Level 2 text will be directly applicable into national law, and therefore will not be subject to a process of transposition.

In October 2013, EIOPA issued guidelines for preparation of Solvency II to ensure that Member States, insurers and reinsurers are starting to look at the various elements of Solvency II to prepare for implementation. As well as including the need for a forward looking assessment of undertakings' own risk (under the ORSA procedure), consideration must also be given to the systems of governance, ways of reporting information,

and methodology in relation to the creation of an internal model use.

Whether to use an internal model approach or base solvency calibrations on the standard formula, remains a contentious point. Level 2 text is designed to provide further insight into the requirements necessary for an approved internal model. The European Commission and EIOPA have always emphasized the benefits that an internal model may bring to larger, or more diverse insurance undertakings. Even so, an internal model approach undeniably creates extensive burdens, including detailing the calibrations, producing user manuals, regulatory approval and monitoring, as well as stringent validation criteria. There is, in addition, the burden that will be placed on the national authorities who will be expected to understand the often highly complex workings of internal models for approval, with oversight from EIOPA, but with otherwise limited additional resources. With some national regulators warning of delays in the approval process of internal models, some insurance groups have already declared a preference for using the standard formula as a first approach and potentially moving towards a more dynamic model once more is known.

The increased certainty of adoption will assure many in the process that the vast sums of investment in the preparation towards Solvency II were not a lost venture. Yet, a new capital adequacy regime attracts the challenge of ensuring that entities can satisfy the requirements as set out under Solvency II. As the security of government bonds is thrown further into doubt, regulators will need to evaluate whether a zero percent capital charge for sovereign debt remains appropriate. We have already seen a trend towards insurers looking at moves from government bonds to higher-rated corporate debt, which indicates that insurers are making a risk/return assessment already in the build-up to Solvency II.

2014 will be a busy year for the determination of additional detail around Solvency II and the restart of the equivalence process for many third-world countries. We are likely to see more preparation underway and a clearer understanding of the ways in which businesses will manage under the forthcoming regime.

The PRA and FCA Twin Peaks

Over nine months have passed since the UK Financial Services Authority (FSA) was abolished and replaced with the Financial Conduct Authority (FCA) and the Prudential Regulation Authority (PRA). Although the insurance industry attempted to predict the outcome of having two regulatory bodies in the lead up to their introduction, the real impact of the "Twin Peaks" approach has only become apparent since its implementation.

The general consensus appears to be that the coordination between the regulators has so far not been what was hoped for. Concerns exist in relation to the PRA's power of veto over the FCA and whether this power will further affect the relationship and cooperation that exists between the two bodies. The fact that numerous firms no longer have dedicated supervisors within the regulatory bodies has intensified matters. Some firms can no longer discuss regulatory matters with an individual at the regulator who knows their business and can assist in putting any queries to the correct regulator. Instead, firms must use a central contact number and speak to staff who are unaware of their business and may have no sense of where a query should be referred.

The industry is becoming increasingly frustrated with respect to the length of time it can take for the regulator to respond and sometimes with the quality of the response once received. This is leading to increased professional fees for firms as they turn to law firms and other professional advisers for advice. The time taken to obtain FCA or PRA authorization for new start-ups has increased considerably and even matters which were deemed to be relatively straightforward prior to the split (such as change of control applications) are now taking considerably longer, as the regulators appear to be increasingly risk adverse.

Although it was recognized that there was a risk of overlap (and under lap) with the Twin Peaks approach, it was generally accepted that such risks could be reduced by the implementation of a plan, as required by the government, to be drawn up between the FCA and PRA to address such risks and to implement arrangements to coordinate their operations. Nine months have passed and such arrangements are yet to be finalized.

Despite concerns raised generally with respect to the scope of the FCA's powers, including the proposal to give the FCA competition law enforcement powers concurrent with those of the UK competition commission and the Office of Fair Trading, the government has introduced an amendment to the Financial Services (Banking Reform) Bill to give the FCA increased competition enforcement powers. It is intended that under the Competition Act 1998 (CA98) the FCA will be equipped with enforcement powers to address restrictive practices by companies operating in the UK that distort, restrict, or prevent competition. Businesses that break the law can be fined up to 10 percent of their worldwide turnover.

PRA's Expectations for Solvency II

On December 12, 2013, the PRA published its Supervisory Statement (SS4/13) on applying EIOPA's preparatory guidelines to PRA-authorized firms. The statement sets out how the PRA expects firms to prepare for Solvency II in order to meet the requirements of the EIOPA guidelines prior to full implementation of Solvency II in 2016.

The material issues covered in the PRA's statement include:

- All insurers must ensure that their systems of governance are Solvency II compliant. The PRA believes that the immediate impact on firms will be limited as the current PRA rules on governance are broadly aligned with Solvency II requirements
- During the preparatory period, firms will be required to undertake two ORSA assessments (one in 2014 and one in 2015) to demonstrate the progress made towards preparing for the submission of the ORSA under Solvency II
- Groups whose undertakings which will be required to produce a group ORSA, in addition to solo company ORSA, are encouraged to make early contact with their supervisor to plan and resource this exercise during the preparatory period in order to be fully compliant when Solvency II is implemented and
- Firms engaged in the internal model pre-application process are required to take steps to put into practice the relevant provisions of the Guidelines as part of their preparation to submit an application to use an internal model.

The PRA's statement is not intended to add to EIOPA's guidelines, but it seeks to provide clarity and sets out how the PRA expects firms to interpret the guidelines.

PRA's Consultation Papers on Schemes and Capital Extractions

September 2013 saw the publication of two consultation papers by the PRA that have caused considerable debate and controversy within the insurance industry. The consultation period for both papers ended in late October. We summarize below the material proposals outlined by the PRA in these papers and the concerns raised by the industry with respect to such proposals.

Schemes of arrangement by general insurance firms (CP6/13).

This paper sets out the PRA's draft supervisory statement on the use of schemes of arrangement by general insurers, which the PRA intends to adopt subject to the responses it received during the consultation period.

The PRA assesses a proposed scheme to determine whether it presents any risks to the PRA's statutory objectives and then informs the court whether it has any objections to the scheme. In the event that the PRA objects to a proposed scheme, the insurer may proceed with the court application, but the PRA's objection would be a matter to which the court would give considerable weight in deciding whether the scheme was fair and reasonable and should be approved.

The draft statement outlines the PRA's approach to determining whether an insurer is acting in a manner consistent with the PRA's statutory objectives of safety, soundness and policyholder protection when promoting a scheme. The PRA's view is that:

- An insolvent scheme may be consistent with statutory objectives where it achieves a better outcome for policyholders than other alternatives and
- A solvent scheme will only be compatible with the PRA's statutory objectives where there are

compelling reasons to take a different approach to secure an appropriate degree of policyholder protection or where alternative safeguards are put in place to ensure an acceptable level of continuity of cover for dissenting policyholders.

The industry has raised concerns with respect to various aspects of the consultation paper, including the requirement to secure an "appropriate degree of policyholder protection and continuity of cover." It is widely felt that this protection is already afforded under the current court process and that this additional level of protection intrudes upon that process. In addition, the industry is concerned that the proposed approach does not differentiate between types of insurer and lines of business, applying equally to live and run-off business, life and non-life insurance providers, *etc*. This appears to be in sharp contrast to the PRA's *Approach to Insurance Supervision* paper issued in April, in which the PRA recognizes that their approach to supervision varies depending upon the type of insurer and line of business.

The prevailing concern is that the approach proposed by the PRA could effectively end solvent schemes of arrangement for insurers.

To date, the PRA has not published its response to the industry concerns raised through the consultation process and so the true impact of the consultation remains to be seen. What is clear is that further information and explanation is required from the PRA with respect to how the proposals will apply in practice to allay market fears.

Capital extractions by run-off firms within the general insurance sector (CP7/13)

This paper sets out the PRA's draft supervisory statement on capital extractions by general insurers in run-off. It highlights some of the factors that the PRA expects senior management to take into account when considering a request to the PRA to extract capital during the course of a run-off and sets out the PRA's general approach when considering such requests.

Factors to be taken into account by insurers

- The firm's solvency position after the proposed extraction (including the quality of policy records held and how its solvency position could change following the implementation of Solvency II) and
- Expected progress of the run-off over (as a minimum) the next three tofive years based on realistic assumptions, in turn founded on factors such as claims, reserve development and investment income.

The board of the firm may only approve the capital extraction application if it is confident that the firm will maintain adequate financial resources after the proposed extraction to meet its minimum capital requirement and individual capital assessment at all times over a threeto five year period. It appears that the PRA considers a run-off firm's capital to be low if it is less than 200 percent of the Individual Capital Assessment/Individual Capital Guidance (ICA/ICG).

The PRA's view is that capital extractions through the life of a run-off weaken the level of protection available for the remaining policyholders. The PRA is particularly concerned with run-off firms as it believes such firms have limited access to further capital and fewer available options to restore capital levels in the event that the capital requirement increases. The PRA states, by way of example, that run-off firms are susceptible to unexpected reserve deterioration through changes in the expected frequency or severity of known risks, and historic policy data can make it difficult to estimate future claims.

The run-off industry has expressed significant concerns with the draft guidance and the PRA's perceived view that capital extractions by run-off insurers are generally bad and weaken policyholder protection. The PRA's view of run-off insurers is considered inaccurate given that live insurers face many of the same risks as those which the PRA has attributed to run-off insurers, including unexpected reserve deterioration and historic policy data. In addition, it is not clear why the PRA considers that the extraction of capital "inevitably weakens the level of protection available to policyholders" when it is only the surplus capital which is extracted, after the existing stringent solvency requirements have been satisfied. There are also concerns around the PRA's proposal to issue firms with an IGC, which appears likely if the capital extraction could reduce the firms retained capital to below 200 percent of a firms ICA/ICG . This is seen as an additional and excessive solvency requirement, which may be applied to a firm wishing to extract capital even in circumstances where that firm meets its solvency requirement.

As with the Schemes consultation, the PRA has not yet published its response to the concerns raised by the industry and so the true impact of the consultation remains to be seen.

PRA and Lloyd's Cooperation Agreement

Since 2001, the UK FSA and Lloyd's have been party to a formal cooperation agreement. The abolition of the FSA and its replacement with the PRA and the FCA, has resulted in the need for Lloyd's to enter into new cooperation agreements with each of the PRA and the FCA.

Lloyd's entered into a cooperation agreement with the FCA in June 2013. However, the execution of the cooperation agreement between the PRA and Lloyd's was only announced on December 16, 2013. The delay in executing the PRA cooperation agreement raised industry concerns that there existed points of contention between the PRA and Lloyd's. The parties have provided no explanation for this delay.

The cooperation agreement between the PRA and Lloyd's seeks to address the possibility of regulatory duplication in areas where managing agents are subject to the supervision of both the PRA and Lloyd's. The agreement further governs information sharing and confidentiality requirements between the two regulatory bodies.

In practical terms, the PRA's cooperation agreement has substantially the same effect as that entered into between Lloyd's and the FCA. Further, there is little difference between these agreements in comparison to the formal 2001 arrangement between the FSA and Lloyd's. Most importantly, the agreement confirms the intention of Lloyd's to continue its previous FSA cooperation agreement, with the new regulatory bodies. The real impact of these cooperation agreements is yet to be seen.

INTERNATIONAL REGULATORY – ASIA

Over the recent years, there have been changes in certain insurance regulatory regimes across Asia, creating many business opportunities in areas such as China, Malaysia and Indonesia. In these countries, the relevant governments have implemented new rules and regulations that both encourage foreign investments as well as sector consolidation through mergers and acquisitions. Insurance companies in China and Thailand have also recently been enjoying relaxed regulations over their investments, and are now allowed to broaden their choice of investments and engage in other businesses. Lastly, insurance companies in Hong Kong, Australia and Singapore should review their internal compliance systems in light of changes to their insurance regulatory framework.

China

Shanghai Free Trade Zone. With the formal launch of the Shanghai Free Trade Zone (Shanghai FTZ) on September 29, 2013, various governmental bodies have released a series of rules and regulations from the end of September 2013 to early October to form the legal framework of the Shanghai FTZ. The framework plan of the Shanghai FTZ issued by the State Council (the "Framework Plan") is the over-arching regulation which sets out the objectives of the Shanghai FTZ for the next two to three years, which includes further opening up of service sectors to foreign investors, reforming the administrative system on foreign investments, developing "headquarter economy" and exploring new forms of trading, accelerating RMB convertibility for capital account items, setting up new models for customs monitoring on goods; and setting up new policies to facilitate investments and innovation.

Under the current regime, incorporating a foreign-invested enterprise (FIE) on a national basis is usually time consuming. In general, an FIE is subject to a three-step approval/registration procedure: (i) project verification by the National Development and Reform Commission (or its local branches) (NDRC); (ii) approval by the Ministry of Commerce (or its local branches) (MOFCOM); and (iii) registration with State Administration for Industry and Commerce (SAIC) (or its local branches). According to the Framework Plan, the approval procedure for the establishment of a FIE is to be substantially liberalized in the Shanghai FTZ for a three-year trial period starting from October 1, 2013. To establish a FIE that does not fall within the "negative list," the approval procedure is now replaced by filing procedures. According to the Filing Procedures Rules, the NDRC verification on foreign investment is now replaced by the project filing procedure (外商投资项目备案) and the MOFCOM approval is replaced by the enterprise filing procedure (外商投资企业备案). Both filings together with the SAIC registration can be submitted either at the same time or separately through a centralized filing system.

In order to provide more flexibility to investors, SAIC issued a circular on September 26, 2013 (SAIC Circular) adopting a new capital registration system in the Shanghai FTZ. Companies are no longer subject to any minimum registered capital and investors are free to decide the registered capital amount based on business needs. The mandatory requirements on capital contribution timetable are also cancelled for companies in the Shanghai FTZ and investors may decide the timetable freely. Also, the 70 percent cap on non-currency registered capital is also lifted by the SAIC Circular. Investors are free to decide the proportion between cash and in-kind capital

There will be an annual reporting system for companies in the Shanghai FTZ in which the information reported will be made available to the public. In general, companies registered in the Shanghai FTZ are no longer subject to approval for their outbound investment under the simplified administrative regime; instead, a straightforward filing procedure is put in place.

As regards taxation, the Framework Plan provides certain preferential tax policies in the Shanghai FTZ, including installment payment of income taxes and tax exemption for imported equipment of manufacturing enterprises or service companies in the manufacturing sector.

There is no doubt that the Shanghai FTZ has attracted global attention to this 28.78-square-kilometer area. The Chinese government has shown its determination to explore fundamental reforms in the zone, making the zone an international economic center and eventually duplicating the successful models on a nationwide basis. However, as one may expect, this is likely to be a gradual process with resistance and setbacks from regulatory bodies at different levels. At this stage, most of the proposed reforms in the Framework Plan are still general outlines without detailed policies and rules, especially for industries where foreign investors have intensive interests, such as insurance, value-added telecommunication, medical service and education. It is expected that more implementing rules will be released in the near future.

Overseas insurance investment regulation update. As part of the effort to liberalize insurance investment and to improve return of insurers' investment, the China Insurance Regulatory Commission (CIRC) promulgated the Implementation Rule of the Provisional Administration Measures on Overseas Insurance Investment with Insurance Fund on October 12, 2012 (the Implementation Rule).

The Implementation Rule is one of the eight new investment regulations that the CIRC has promulgated this year. The Implementation Rule provides a clear framework that enables qualified insurers to invest in permitted scopes of financial products (*e.g.*, money market instruments, fixed income instruments, equity instruments and certain security funds, private equities in designated sectors and real estate investment trusts) and real estate projects in designated jurisdictions, where any investment in equities of non-listed enterprises is limited to designated sectors including finance, senior care, medical care, energy, *etc*. Moreover, authorized insurers are no longer required to obtain prior approval for overseas investment and only need to file reports for such investment quarterly and annually (or on an ad hoc basis for urgent and important matters).

For an insurer to qualify for such a license of overseas investment, the insurer shall maintain its solvency margin at 120 percent or above, which is lower than the minimum requirement of 150 percent in a draft released in July. In addition to the conditions required for a general overseas investment license, an insurer must also satisfy qualification requirements for a particular investment (if any).

The insurance investment in overseas markets is limited to 15 percent of the insurers' total assets. Separately, investments in 20 permitted developing countries are capped at 10 percent of the total assets. Foreign assets management companies that are designated to manage the insurance investment must meet certain criteria including (i) over five years of international assets management experience and over three years of pension or insurance assets management experience; (ii) no less than US$30 million paid-in capital or net assets; and (iii) no less than US$30 billion managed assets, of which non-related parties' assets account for over 50 percent or are worth at least US$30 billion (with limited exceptions). According to relevant regulations, the financial supervisory body of the country or region where such foreign assets management company comes from should have signed a supervision cooperation document with China's financial supervisory authorities.

In the context of a weak domestic capital market and immature investment environment, top insurers in China are motivated to look elsewhere for investable assets. The Chinese insurance fund with hundreds of billions of RMB can bring a great potential of opportunities for the industries and countries listed in the Implementation Rule.

Hong Kong

Key Legislative Proposals on Establishment of the Independent Insurance Authority in Hong Kong. At present, the regulation of insurers in Hong Kong is governed by the Insurance Companies Ordinance (Cap.41) (ICO). Under the ICO, the Insurance Authority is empowered to grant authorization to insurers and to exercise prudential regulation over insurers. Insurance intermediaries, such as individual agents, brokers and insurance agencies, are regulated under a self-regulatory regime administered by three Self-Regulatory Organizations (SROs), namely Professional Insurance Brokers Association, the Hong Kong Confederation of Insurance Brokers and the Hong Kong Federation of Insurers. Banks which carry out insurance intermediary activities are also subject to supervision by Hong Kong Monetary Authority (HKMA).

The key legislative amendments to the ICO cover the following topics:

- **Establishment of the Independent Insurance Authority (IIA)**. To align with international practice of financial services regulators being financially and operationally independent, the IIA will be established as a corporate body with a governing board comprised of members from a cross-section of the community, with some possessing expertise and knowledge of the insurance industry. The board members are to be appointed by the Chief Executive. To maintain the independence of the IIA, no representatives from the government will be appointed to the board
- **Statutory licensing regime for insurance intermediaries**. Under the proposals, the IIA would be responsible for licensing and regulation of insurance intermediaries. The legislative proposals replace the existing provisions on self-regulation with a new licensing regime. Similar to the regulatory regime under the Securities and Futures Ordinance (Cap 571), the legislative proposals require a person to be licensed to carry out "regulated activities." "Regulated activities" have been defined to cover a wide range of activities, including negotiating or arranging a contract of insurance and giving regulatory advice on any one of the insurance related matters listed in the legislative proposals ranging from making of an insurance application, to termination of insurance, to the exercise of a right under an insurance contract
- **Conduct regulations and roles of responsible officers**. Licensed insurance intermediaries will be required to observe certain standards of conduct. The proposed legislative amendments merely set out the principles of these conduct requirements; details will only be provided in subsidiary legislation and further non-statutory guidance in due course. It is proposed that each corporate licensee should be required to appoint a responsible officer (a concept mirroring the notion of "responsible officer" under Securities and Futures Ordinance (Cap. 571) and the Mandatory Provident Fund Schemes Ordinance (Cap.485)). Such responsible officer will be

responsible for ensuring that internal control and procedures are in place in compliance with the conduct requirements and are observed by all intermediaries engaged by the corporate licensee. It is also proposed that each authorized insurer should appoint a responsible officer to ensure systems in place for securing compliance by its appointed insurance agents with the conduct requirements. For this purpose, the proposed legislative amendment has a deeming provision whereby the chief executive officer of an authorized insurer will automatically become the insurer's responsible officer and

- **Investigative and disciplinary powers**. The proposed legislative amendments confer powers on the IIA to undertake inspections and investigations into the conduct of insurers and intermediaries. The IIA is also empowered to impose disciplinary sanctions against licensed insurance intermediaries, the responsible officers and insurers for misconduct and breach of the "fit and proper" requirements, and to prosecute offences summarily. To ensure proper checks and balances on the IIA's exercise of these powers, the amendments provide for various statutory safeguards, such as IIA having the obligation to conduct fair hearings and give reasons for the disciplinary sanctions it imposes. Under the proposals, the IIA would become the primary and lead regulator for conduct of insurance regulated activities for insurance intermediaries.

The government aims to introduce the finalized Insurance Companies (Amendment) Bill into the Legislative Council in 2014, so that the IIA can come into operation in 2015. The establishment of an independent watchdog will bring Hong Kong in line with international practice. This should result in better protection of insurance policyholders and enhance confidence in the industry. However, with the IIA being armed with extensive inspection, investigative and disciplinary powers, conduct of the insurers and intermediaries will come under increased scrutiny going forward. Insurers and intermediaries should take this as a timely opportunity to review and revamp their internal compliance systems to ensure the risks of carrying out insurance business are effectively managed.

Indonesia

Recent key changes in the highly regulated insurance regulatory regime have created potential M&A opportunities in the Indonesian insurance market.

On January 1, 2013, an independent institution named Otoritas Jasa Keuangan (or Financial Services Authority, OJK), established under Law no. 21 of 2011 regarding Financial Services Authority, took over the regulation and supervision of the capital markets and financial sectors, including the insurance sector.

In general, foreign shareholdings of any entity carrying on insurance activities are limited to 80 percent. A foreign shareholder in an Indonesian (re)insurance company must either be (i) a(n) (re)insurance company in the same line of business as that of the joint venture insurance company (in life insurance, general loss insurance or reinsurance business), or (ii) a holding company with a majority of its portfolio investment in (re)insurance companies. An exception to this 80 percent limit was introduced by Government Regulation in 1999, which allows, at the ultimate discretion of the OJK, existing foreign shareholders in (re)insurance companies to increase their shareholdings beyond the 80 percent limit by injecting more capital into the company (resulting in a dilution of the Indonesian 20 percent shareholder(s)). This exception was introduced in the context of mandatory requirements for Indonesian (re)insurance companies to increase their capital in order to meet higher risk based capital requirements.

In 2008, paid up capital requirements were introduced, which require insurance companies to increase their minimum capital levels in three stages, up to IDR100 billion by December 31, 2014, and reinsurance companies are required to have a minimum capitalization of IDR200 billion by the same date. Judging from the experience of the previous two stages of capital increase (in December 31, 2010 and December 31, 2012), some local insurers will probably struggle to meet the mandatory capital increase requirements by the stated deadline and this could create new investment opportunities for foreign insurers and reinsurers. According to official reports of OJK's predecessor as insurance regulator:

- 15 insurance companies (5 life, 8 general and 2 takaful) were unable to meet the December 31, 2010 capital increase deadline, and 2 licenses were revoked in 2011 and
- As of May 2012, 23 general insurance companies and eight life insurance companies had yet to meet the capital increase requirements, 6 licenses were revoked in 2012 and the license of PT Asuransi Chubb Indonesia was revoked in the 1st Quarter of 2013.

Malaysia

During the past three years, the insurance market in Malaysia has seen a surge in M&A activity, the main drivers of which were (and continue to be) the implementation of the risk based capital regime and the increase of the foreign investment cap.

The Risk Based Capital Framework (RBCF) was introduced by Bank Negara Malaysia (BNM) in April 2007 and became effective on January 1, 2009 for Malaysian insurers and reinsurers. A similar regime for takaful and retakaful operators, the Risk-Based Capital Framework for Takaful Operators (RBCTO), was issued on October 30, 2012 and shall take effect from the financial year beginning January 1, 2014. The regulatory regime for takaful and retakaful operators was previously more "light touch," and one effect of the RBCTO should be to place (re)takaful operators on a substantially more level playing field as conventional (re)insurers. The RBCF has already resulted in some "big ticket" M&A, such as the sale of Malaysia Assurance Alliance Berhad (MAAB) to Zurich (as part of this deal, Zurich had to inject up to US$172 million into MAAB to comply with RBCF requirements). On the takaful side, even prior to the issuance of the RBCTO, there have been signs of some M&A to boost capital ahead of the RBCTO requirements for (re)takaful operators, such as the aborted sale of up to 49 percent of Takaful Ikhlas to Allianz (which was called off in July 2011).

In 2009, the foreign direct investment cap was increased from 49 percent to 70 percent. An even higher percentage of foreign shareholding may be allowed on case-by-case basis to facilitate consolidation and rationalization of the Malaysian insurance industry. This has resulted in some M&A, such as NKSJ Holdings (the parent of Sompo Japan Insurance) increasing its 30 percent stake in its Malaysian insurance joint venture, Berjaya Sompo Insurance to 70 percent. Furthermore, some recent M&A in the market will likely trigger further M&A in the form of "sell downs" to 70 percent (such as Zurich's current 100 percent stake in MAAB).

An example of BNM permitting 100 percent foreign shareholding due to the relevant foreign investor being able to facilitate consolidation / rationalization of the Malaysian insurance industry may be seen in ACE acquiring an additional 49 percent of ACE Synergy Insurance Berhad to hold 100 percent of this general insurer. ACE had, prior to this, acquired 100 percent of another general insurer, Jerneh Insurance. In the 1st Quarter of 2012, ACE consolidated both of these general

The insurance market in Malaysia has seen a surge in M&A activity, the main drivers of which were (and continue to be) the implementation of the risk based capital regime and the increase of the foreign investment cap

insurers by portfolio transferring ACE Synergy Insurance's general insurance business into Jerneh Insurance and rebranding the combined business as ACE Jerneh.

The Financial Services Act 2013 (FSA) and the Islamic Financial Services Act 2013 (IFSA) became effective on June 30, 2013 and consolidated the various legislation pertaining to banking, investment banking, insurance and payment systems businesses, and the oversight of the money market and foreign exchange administration in Malaysia.

The FSA has a potential M&A impact on Malaysia's insurance sector as it prohibits an insurer from carrying on composite (both life and general) insurance business. A transitional period of five years (by 29 June 2018) applies for composite insurers to either reorganize their general and life insurance businesses into separate entities or to divest one of these lines of business. The reorganization option would involve setting up separate entities to manage the general insurance and life insurance businesses, and also having separate CEO and other key management positions, boards of directors, actuaries and operating systems. This will clearly result in an increase in operating expenses but the immediate profit-and-loss impact of this could be spread out over the 5 year transitional period. This is expected to nurture and promote the long-term health of the industry because life insurance and general insurance businesses have different risk profiles. The segregation of life and non-life insurance businesses will align Malaysian insurers with their counterparts in various developed countries and is likely to result in M&A involving such of the composite insurers (*i.e.*, AIA, Etiqa Insurance, MCIS Zurich Insurance, Zurich Insurance Malaysia and Prudential Assurance Malaysia) which are unable to pass on the costs of reorganizing their current businesses to policyholders and unwilling to absorb such costs themselves. In addition, the FSA further prohibits any individual investor from holding more than a 10 percent interest in shares of a licensed institution, which include licensed (re)insurers. "Interest in shares" under the FSA includes direct interests, effective interests and legal/beneficial interests. There is a transitional period of five years (by June 29, 2018) for the affected individuals (*i.e.*, Tan Sri Azman Hashim of AmLife Insurance, AmGeneral Insurance and AmFamily Takaful, Tan Sri Quek Leng Chan of Hong Leong Assurance and Hong Leong MSIC Takaful and Tan Sri The Hong Piow of Lonpac Insurance) to "sell down" their current stakes to 10 percent or less.

Singapore

2013 saw significant changes to the regulatory regime for insurers in Singapore with the amendments to the Insurance Act (CAP 142) which came into force on April 18, 2013. The four most significant changes are: (i) amendments to the change of control regulations; (ii) new requirements on insurance companies to obtain approval before acquiring major stakes in other corporations; (iii) clarification on the consent required for business transfers; and (iv) a new prohibition on branch offices soliciting insurance business in Singapore for their head offices.

The new change of control provisions. By way of background, there are two principal change of control provisions under the Act. The first is triggered where a person obtains "effective control" of a licensed insurer incorporated in Singapore (now section 28 of the Act). The second is triggered where a person obtains a substantial shareholding (five percent interest or more) of a licensed insurer incorporated in Singapore (the new section 29 of the Act).

The new amendments provide that notification to and approval from the regulator (the Monetary Authority of Singapore (MAS)) must be obtained prior to a person obtaining effective control (including *de facto* control) or a substantial shareholding. Furthermore, Section 28 now expressly states that a person will have effective control where the directors of the insurer are accustomed or required to act on the acquirer's instructions (section 28(7)(a)(ii)).

The amendments also provide the MAS with enhanced powers to enforce change of control regulations. Sections 29A and 29B provide that where Sections 28 or 29 are not complied with, the MAS may issue a written notice of objection to the acquiring person and make any direction it deems necessary, including directing the disposal of any interest in the target insurer.

Notwithstanding the amendments to the change of control provisions in Sections 28 and 29 of the Act, it should be noted that those provisions only apply to licensed insurers incorporated in Singapore, and therefore they do not apply to branch offices of insurers incorporated overseas.

MAS approval required for acquisitions of "major stakes" in other corporations. New section 30B of the Act introduces new notification requirements for licensed insurers which obtain major stakes in other corporations.

Non-Singapore incorporated insurers who hold a "major stake" in another corporation as part of the assets of any Singapore regulated insurance fund must now obtain approval of the MAS in order to continue to hold such assets. A similar requirement applies to non-Singapore incorporated insurers who acquire a major stake in another corporation using the assets of a Singapore regulated insurance fund. A "major stake" is: (i) a beneficial interest in 10 percent or more of issued shares; (ii) control over 10 percent or more of voting power; or (iii) any interest giving *de facto* control over the corporation.

Approval from the MAS must also be sought by all licensed insurers established or incorporated in Singapore before obtaining a major stake in another corporation.

This new section means approval of the MAS must be obtained for investment of insurance funds into 10 percent of more stake in a corporation.

MAS approval for business transfers. The amendments to the Act clarify that, in the case of business transfer (that is a transfer of the assets in a licensed insurer), MAS consent is required even where the transfer is effected by the novation of the policies in the book to be transferred.

Prohibition of branch offices soliciting business. New Section 6(2) of the Act provides that a person who solicits any insurance business for a licensed insurer or any other insurer entitled to carry on insurance business in Singapore (including a branch office of a foreign insurer) shall not solicit insurance business for any branch located outside Singapore or the head office of that insurer. This new section will restrict the nature of marketing activities that may be carried out by on-shore staff.

Thailand

On October 25, 2013, new regulations became effective which govern how life and non-life insurers in Thailand may conduct investment and engage in other business activities.

An investment committee must be appointed by the insurer. It must be comprised of at least three persons, who shall be directors/executives, and "knowledgeable and skilled persons" who have at least three years' experience in investment management, risk management or securities analysis. The committee has a supervisory role. Among other things, it must develop an investment policy framework and consider and approve investment plans, supervise and manage investment, oversee transparency and accountability of investments, and report investment results to the insurer's board of directors. An investment unit should be developed by the insurer, responsible for the operational role in undertaking investment. Within two years, responsible person(s)/investment decision maker(s) within the unit must complete an official training course and have certain financial/economic qualifications and/or experience. Otherwise, an external party, who must be either a licensed personal fund manager or approved for

the role by the insurance regulator, can be appointed to oversee the investment unit.

The regulations prescribe that insurers may invest by way of bank deposits, equity instruments (generally, up to 10 percent of the total issued shares may be acquired), debt instruments and hybrid instruments (*e.g.*, convertible debentures) *etc.*, subject to certain limitations on investment proportions. Further, subject to certain conditions, insurers may engage/invest in 'other' business such as letting or subletting real estate, conducting back office services, *etc*. In this regard, a supervisory committee and an internal control system must be established for the conduct of other business, and income from each 'other business' must be separated according to generally accepted accounting principles.

Several documents such as investment policy framework and investment plan, risk management procedure, policy for conducting other business, investment manual, and risk management procedure for conducting other business must be developed and submitted to the insurance regulator. These documents must also be reviewed and resubmitted annually (except the investment manual where it has to be developed within 90 days of the end of 2013, and submitted to the regulator within 30 days of completion). There is also a general requirement to submit to the regulator details of any material changes to these documents within 30 days.

INTERNATIONAL REGULATORY – AUSTRALIA

Other than the amendments to the Insurance Contracts Act, there was been minimal regulatory change for the insurance industry in 2013. The change of federal government in September 2013 and the election period likely impacted legislative activity. We expect to see more substantive changes over the course of the next 12 to 18 months.

Insurance Contracts Amendment Acts. The long awaited amendments to the Insurance Contracts Act 1984 (Act) contained in the Insurance Contracts Amendment Bill 2013 (Amendment Act 2013) were passed by Parliament on June 20, 2013 and received Royal Assent on June 28, 2013. As the Parliamentary Secretary to the Treasurer, the Honourable Mr Rippol stated in the Second Reading Speech:

"Although many of the amendments are technical adjustments to the Act rather than significant changes to the framework of the Act, as a package they will operate to streamline and clarify requirements while maintaining appropriate consumer protections."

Insurers, insureds and insurance brokers will all be affected by the Amendment Act 2013, which changed and clarified the scope of the Act. The Amendment Act 2013 shifts some responsibilities from the insured to the insurer and *vice versa*.

The key changes affecting contracts of general insurance contained in the Amendment Act 2013 include:

- The application of the duty of utmost good faith
- Allowing for the use of electronic communications for statutory notices and documents
- Making the duty of disclosure easier for consumers to understand and comply with, especially at renewal of household/domestic insurance contracts

- Making the remedies in respect of life insurance contracts more flexible and suited to modern life insurance products
- Clarifying the rights and obligations of persons named in contracts has having the benefit of cover, but who are not parties themselves and
- Clarifying what types of contracts are exempt from its operation.

The changes to the duty of disclosure for retail products will require insurers to change their existing processes. Some of the amendments have commenced whilst other amendments will commence at varying times over the next two and half years.

FOFA Reforms. The Future of Financial Advice reforms have been mandatory since July 1, 2013. The FOFA reforms introduce changes to implement the following:

- A ban on conflicted remuneration
- A statutory fiduciary duty for financial advisers
- Increasing transparency and flexibility of payments for financial advice
- Restrictions on percentage-based fees
- Expand the availability of low-cost "simple advice" to improve access to and affordability of financial advice and
- Strengthen the powers of the Australian Securities and Investments Commission (ASIC) to act against unscrupulous operators.

The Australian federal government has confirmed its support in principle of the reforms but at the same time signaled an intention to review and make some changes. The Australian government intends to wind back the 'opt-in' provisions. The bulk of the FOFA reforms are likely to remain unchanged.

Looking ahead. Since the September federal election, there has been a public reaffirmation of the Australian federal government's intention to review current legislation and prepare an agenda of reform for the financial services sector. The Australian federal government has revealed an aggressive plan to reduce regulation. In a recent address to Association of Independently Owned Financial Professionals, Assistant Treasurer Arthur Sinodinos gave a number of examples to demonstrate the government's commitment to reform, including each of the following:

- Establishing a red and green tape reduction target of US$1 billion per year in compliance costs, requiring agencies (including the Treasury portfolio) to identify (in dollar terms) measures that offset the cost impost to business of any new regulations and
- Requiring agencies to calculate the compliance costs of existing and any new or repealed legislation.

Regulators like ASIC, APRA, the ACCC and the ATO will also be impacted. The government has requested the Productivity Commission to prepare a framework for auditing the performance of regulatory agencies.

The Assistant Treasurer also stated in this recent address that: "the Government will place a moratorium on new significant regulation. Legislation and regulation will continue where it is necessary to provide certainty to industry, where there is an overwhelming case for urgent action, or if needed to implement election commitments. The moratorium will not affect instances where industry has already made significant investments to prepare for the completion of major reforms." We anticipate the bulk of any substantive legislative change in the insurance sector will occur once the Financial Sector Inquiry has been completed.

COMPLIANCE

EU Data Protection Directive

Proposed changes to the EU Data Protection Directive are going to impact all organizations (including the insurance sector) operating both locally and globally where they process or otherwise handle personal data and are subject to compliance with European data protection laws.

On January 25, 2012, the European Commission proposed a fundamental and comprehensive reform to the existing data protection framework, being the 1995 Data Protection Directive (*Directive 95/46/EC*) (the Regulation). The aim of the draft Regulation is to harmonize the existing data protection regime and impose a single law that will make it easier for businesses operating across multiple jurisdictions. Since January 2012, there have been months of negotiations undertaken between the various parliamentary committees including the European Parliament's

Committee on Civil Liberties, Justice and Home Affairs (LIBE), which have been in charge of reaching an agreement on the "compromise text" of the Regulations in the European Parliament. The next step in the process is for the Council of Ministers to agree on the Regulation, following which the final text must be agreed. A vote is expected before the parliamentary elections in May 2014.

What does this mean for the Insurance Sector? The draft Regulation will have a significant impact on all businesses operating in and around the European Union and beyond. As the proposed legislation is in the form of a regulation the provisions would be directly applicable into national law, meaning that national governments would not be able to offer the same flexibility of approach which is currently afforded to companies in certain jurisdictions such as the UK. For those organizations operating within the insurance sector, the proposed changes in the application of the law and harsh sanctions for non-compliance will have a significant impact.

Summary of Proposed Changes Relevant to the Insurance Sector. Some of the key changes which are likely to have an impact upon the insurance sector include:

- **Legal Obligations for Data Processing**: the Regulation imposes legal compliance obligations upon a data processor which previously has not been the case. This shift in responsibility increases the exposure for insurers (and reinsurers) processing personal data (*e.g.* policies) on behalf of a data controller, who would then become directly responsible for compliance
- **Data Minimization and Records Retention**: data minimization requirements will require insurers to ensure that only the minimum amount of data is used, processed and otherwise stored. The proposed obligation to limit the usage of personal data may impact upon the way in which insurers current access personal data from multiple sources to evaluate risk
- **Automatic Profiling Restrictions**: insurance practices which require profiling of consumers and risk scoring are also being restricted under the Regulation. In particular, reliance upon information which has been automatically scored is being restricted
- **Sensitive Data and "Gender Identifiers"**: the definition of sensitive data is to be amended to include "gender identity." Restrictions on the use of gender identifiers may limit the way in which insurers currently collect and process consumer personal data and make the process much more onerous
- **Consent**: consent has been revised and would mean that it needs to be explicit, involving affirmative action by the data subject so that reliance upon implied consent (*e.g.* inaction by the data subject) would no longer be valid. This change will significantly impact to the way in which insurers currently collect personal data (both online and otherwise)
- **Portability of Data and Access**: this will mean that consumers are to be given enhanced rights to move their personal data which will result in insurers having to implement measures to ensure that consumers have the ability to take their data in readily available format, which could then be used by another insurer
- **Personal data breach**: mandatory reporting obligation following a data breach could increase the number of reported data breaches significantly both for insureds and those insurers processing personal data. A 72-hour time frame for reporting a breach has been proposed
- **Harmonization of Laws**: one of changes which is seen as a positive step is the introduction of a "One Stop Shop." This should offer greater harmonization and certainty, which otherwise has been a complex area to navigate and
- **Cross-Border Data Transfers:** a prohibition on disclosing personal data to a court or administrative authority of a country that is not deemed to be "adequate" by the European Commission has been introduced. This would have an increased administrative burden for insurers operating across multiple jurisdictions and especially those who may be subject to such requests from non-EU regulatory bodies or courts.

The result of these changes will have a significant impact upon the way in which the insurance industry as a whole collect, use, store, transfer, or otherwise process personal data. As it currently stands, non-compliance with the Regulations could result in fines of up to €100 million or up to 5 percent of the annual worldwide turnover, whichever is greater.

Foreign Account Tax Compliance Act (FATCA)

The Internal Revenue Service released Notice 2013-69, including a draft Foreign Financial Institution (FFI) Agreement and several intended updates to the existing Treasury Regulations implementing FATCA. The draft FFI Agreement outlines the obligations of FFIs that will register with the IRS to become participating FFIs (PFFIs) under FATCA. IRS Revenue Procedure 2014-13 contains the final FFI Agreement. Most of the changes made to the draft FFI Agreement and finalized in the FFI Agreement were non-substantive and modify cross-references to anticipated future regulations and revise technical errors. In addition, the Final FFI Agreement: (1) establishes a two-year transition period during which a reporting Model 2 FFI may elect to apply the due diligence procedures that are described in the FFI agreement (instead of those in Annex I of an applicable Model 2 IGA), and (2) provides that for calendar years 2015 and 2016, PFFIs required to report foreign reportable amounts paid to non-participating FFIs must so report on Form 8966.

FFIs and their branches located in countries that have entered into a Model 2 intergovernmental agreement (IGA) with the United States (Model 2 FFIs) will also be required to agree to comply with the terms of an FFI Agreement, as modified by the terms of the applicable Model 2 IGA. PFFIs and Model 2 FFIs will avoid the new 30 percent FATCA withholding tax on US source payments made to FFIs, beginning July 1, 2014.

The Draft FFI Agreement. The draft FFI Agreement comes on the heels of the opening of the FATCA Registration Website in August this year. PFFIs and Model 2 FFIs must agree to comply with the terms of an FFI Agreement as part of their FATCA registration. The draft FFI Agreement is substantially consistent with the final Treasury Regulations implementing FATCA and subsequent Treasury guidance. The Notice provides that the draft FFI Agreement will be finalized by December 31, 2013. With respect to a PFFI or a branch of a PFFI, the effective date of an FFI Agreement is the later of the date on which the IRS issues a Global Intermediary Identification Number (GIIN) to the PFFI or its branch, or June 30, 2014. An FFI Agreement entered into by a PFFI or Model 2 FFI will expire on December 31, 2016, unless terminated under the terms of the FFI Agreement on an earlier date. An FFI Agreement may be renewed by a PFFI or Model 2 FFI under the procedure set forth in the FFI Agreement.

New FATCA Category For Passive NFFES. Under forthcoming Treasury Regulations, non-financial foreign entities (NFFEs) that would otherwise be classified as "passive NFFEs" will be able to avoid being so classified if they (i) elect to report directly to the IRS on Form 8966 (FATCA Report) certain information about their direct or indirect substantial US owners, in lieu of providing such information to withholding agents or PFFIs, and (ii) register with the IRS to obtain a GIIN. Withholding agents and PFFIs will have to identify and document these "direct reporting NFFEs" in a manner similar to how they will document a PFFI, including by verifying the direct reporting NFFE's GIIN on the published IRS FFI List.

This new category is a welcome development because it allows NFFEs to avoid disclosure of their ownership structure to withholding agents and PFFIs – a particularly sensitive issue for certain foreign trusts and property and casualty insurance and reinsurance companies.

Certain Section 953(d) Companies Now Considered US Persons. The Notice specifies that the IRS and Treasury intend to modify the definition of "US person" in the final Treasury Regulations implementing FATCA to include certain foreign insurance companies that have elected to be treated as domestic corporations for federal tax purposes. As a result, property and casualty insurers and reinsurers and other insurers and reinsurers that are not "specified insurance companies" that have made such an election generally should not be subject to FATCA reporting. The final Treasury Regulations implementing FATCA exclude such electing entities from the definition of a US person if such entities are not licensed to do business in any state.

Coordination of Backup Withholding With FATCA Withholding. In the case of a withholdable payment that is also a reportable payment made by a PFFI or Model 2 FFI to a recalcitrant account holder, backup withholding will not apply if tax is withheld under FATCA, unless backup withholding is elected.

Coordination of Form 1099 Reporting With FATCA Reporting. PFFIs and FFIs that are not US payors or US middlemen and that are located in IGA countries will be excused from Form 1099 reporting if they report relevant account information pursuant to an FFI Agreement or pursuant to an applicable Model 1 IGA.

FATCA Enters Into Force Soon. Withholding under FATCA begins July 1, 2014. Financial institutions that have not already considered the steps necessary to become FATCA compliant should do so now. Starting in January 2014, financial institutions will be expected to finalize their registration information. This should be done by April 25, 2014, in order to be included on the first monthly IRS FFI List, which will be posted on June 2, 2014 and used for verification by withholding agents.

District Court Finds that Insurance Premium Excise Tax Does not Apply to Retrocession Transactions

On February 5, 2014, the US District Court for the District of Columbia held that the federal excise tax (the FET) on insurance and reinsurance premiums does not apply to retrocession insurance transactions. Generally, section 4371(3) of the Internal Revenue Code of 1986, as amended (the Code) imposes a 1 percent tax upon each policy of reinsurance whereby a contract of reinsurance is made, continued or renewed, if issued (1) by a nonresident alien individual, a foreign partnership or a foreign corporation, as reinsurer; and (2) to any person against, or with respect to any policy of (A) casualty insurance or an indemnity bond, or (B) life, sickness, or accident insurance, or annuity contract, in each of (A) and (B) where the insurance related to US-situs risks.

The IRS has taken the position that the FET applies on a "cascading basis"—that is, it applies sequentially to every insurance and reinsurance arrangement regarding the same US risk without regard to whether such risk has already been subject to the FET. In January 2013, Validus Reinsurance, Ltd., a Bermuda based reinsurer, filed a tax refund suit in the US District Court for the District of Columbia challenging the imposition the FET on a cascading basis on premiums that it paid in connection with retrocession contracts it entered into outside of the US with non-US reinsurers where a portion or all of the underlying insurance risks were US-situs. The court found that the case presented a straightforward question of law—does Section 4371(3) (which applies to reinsurance transactions) impose the FET on retrocession insurance transactions as well? The court concluded that under the plain language of the statute, the definition of the term "policy of reinsurance" did not include retrocessions. Accordingly, the court granted the taxpayer's motion for summary judgment and ordered the US to refund the money Validus paid to satisfy the claimed deficiency.

In its conclusion, the court stated that Section 4371 does not impose an excise tax on retrocession insurance transactions and explicitly noted that its "decision is in no way predicated on [Validus'] argument that Congress did not intend and does not have the power to tax purely foreign-to-foreign insurance transactions." Thus, a foreign direct insurer that reinsures US-situs risks with a foreign reinsurer is still potentially subject to extraterritorial application of the FET.

COMMERCIAL AND TRANSACTIONAL ISSUES AND TRENDS

Antitrust Issues

United States. In 2013, an important antitrust development, with implications for insurers, was the Supreme Court's decision on the state-action doctrine in *Federal Trade Commission v. Phoebe Putney Health System, Inc.* This decision (decided February 19, 2013, and available here) could affect many insurers because the insurance industry often relies on the state-action doctrine to protect its collective action from antitrust claims.

The state-action doctrine allows states to displace competition, in favor of regulation or monopoly, if two essential elements are met. The two requirements are that the state *(1) must "clearly articulate" its intention to exempt the activity from competition and (2) must "actively supervise" the exempt activity.* (If the anticompetitive activity is itself carried out by a government entity, then only the first requirement applies.)

The state-action exemption is important to insurers and reinsurers. Typical examples of its use include cases where insurers are required by law to collaborate on rate submissions or to take other joint activity with competitors. Normally, collaboration among competitors on sensitive issues like price or output would raise serious questions about whether the joint activity could be seen as a conspiracy to restrain trade.

In the past, state-action doctrine defenses have typically failed when one of the two essential elements – either "clear articulation" of intent to displace competition, or the "active supervision" of the exempted activity – was missing. In many cases, the participants, and perhaps even the state itself, may have assumed these essential elements had been satisfied. That was the case in *Phoebe Putney.*

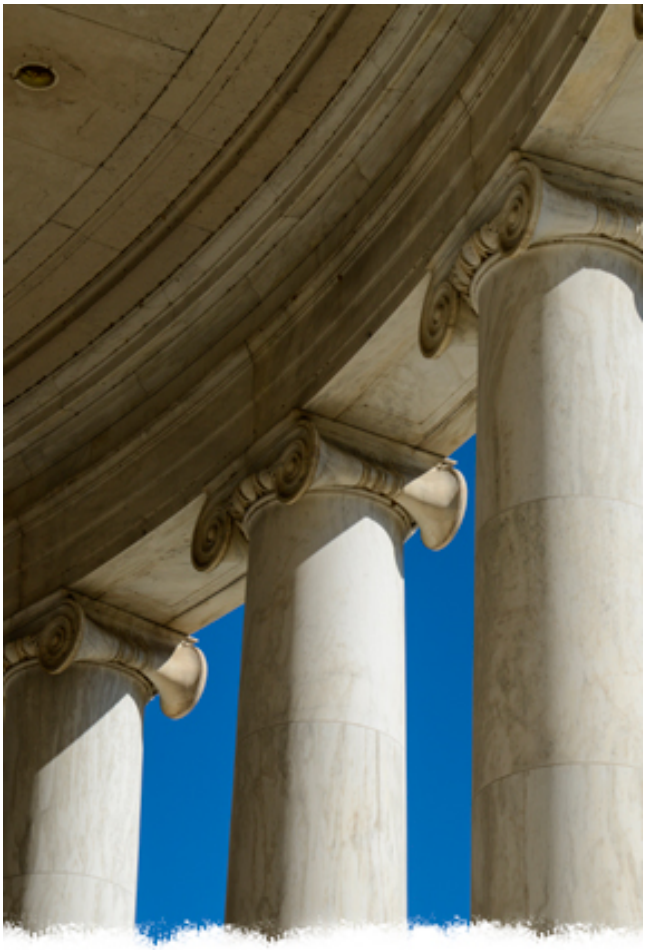
Phoebe Putney involved a hospital merger which was claimed and found by lower federal courts to have been immune from antitrust law because of a state exemption. A Georgia law had created special-purpose hospital authorities and gave them general corporate powers. These included the authority "to provide a mechanism for the operation and maintenance of needed health care facilities in the several counties and municipalities of th[e] state," as well as the powers to "exercise public and essential governmental functions," "all the powers necessary or convenient to carry out and effectuate" the law's purposes, and the power "[t]o acquire by purchase, lease, or otherwise and to operate projects."

The Supreme Court reversed the district court and Eleventh Circuit. Turning to the first state-action test ("clear articulation"), it found that the statutes were inadequate. The Court agreed that the test did not require an "express" statement authorizing the activity. Instead, the Court said, it would be enough if the anticompetitive effect was "foreseeable result" of the state's authorizing law. The Court said, "we recognize state-action immunity only when it is clear that the challenged anticompetitive conduct is undertaken pursuant to a regulatory scheme that 'is the State's own.'"

In *Phoebe Putney*, the Supreme Court found that the "there is no evidence the State affirmatively contemplated that hospital authorities would displace competition by consolidating hospital ownership." Despite the broad powers given to the hospital authority, the Court concluded that there was no authority "to act or regulate anticompetitively." In fact, the Court observed that only a relatively small proportion of the powers delegated by the State to the hospital authority had the ability to reduce competition. As a result, the Court concluded "this is too slender a reed" to rely on for "clear articulation" of an intention to create antitrust immunity.

The Court summed up, saying, "'simple permission to play in a market' does not 'foreseeably entail permission to roughhouse in that market unlawfully.'"

The failure to critically verify the pre-conditions for the state-action doctrine is not a new story. In the past there have been other failures within the insurance industry. In fact, one of the leading cases in this area, *FTC v. Ticor Title*, 504 US 621(1992), is a great example of a failure to verify the "active supervision" test. In *Ticor,* title insurance industry members used rating bureaus to set joint rates and file them with the states. The insurers relied on the state-action doctrine, citing state authorization for the rating bureau activity and the states' power to review rate filings that were made. In point of fact, many of the filings were "inertia" filings, which became effective automatically after the passage of time unless the state insurance regulator failed to veto them. Indeed, many of the states never reviewed the



filings at all. As a result, in that case, there was a failure to "actively supervise" and the defense failed.

The lesson here is that anyone who relies on the state-action doctrine for antitrust immunity needs to independently ensure that there is (1) "clear articulation" and (2) "active supervision" of the anticompetitive activity. Merely assuming that these two critical elements are satisfied is just not enough and could involve very serious ramifications.

European Commission. An important antitrust development in the EU, with implications for Bermuda and other reinsurance centers, was the release of the EU report, *Study on Co(re)insurance* (February 8, 2013 and available here).

Readers may recall that the EC eliminated most of their insurance immunity (the so-called block exemption) in March 2010 (Reg. No. 267/2010, March 24, 2010). As a practical matter, all that remains are (1) insurance and reinsurance pool; and (2) joint compilations of tables and studies, both subject to conditions. This exemption will expire March 31, 2017 unless renewed.

The EU report, *Study on Co(re)insurance* (February 8, 2013), ¶1.6, raises a question about the eventual renewal of the block exemption. The Report also found that, although the market seems competitive, there were still questions about some pools and line slips that apparently were unaware of the pre-conditions of the EU block exemption, including the definition of a "pool." For example, Section 2.234 ff. criticized some pools for failure to conduct "self-assessment" – meaning that they failed to perform a proper market-share analysis, which is the precondition to using the immunity in some cases. Finally, the Report, ¶1.18, noted the ongoing presence of "best terms and conditions" clause, that the EC warned "might well fall within the scope of Article 101(1) and (3) of the Treaty…"

In other words, the situation on immunities in the EU seems to be similar to that in the US. Companies continue to assume they fall within antitrust immunities. In fact, they sometimes fail to do their due diligence to make sure that the pre-conditions for the immunity they rely on are actually met.

Trends in Insurance M&A in 2013 and Beyond

Some reports indicate that insurance M&A activity had not increased significantly for the year 2013 when compared to 2012. Certainly the data supplied by Thomson Reuters for first-half deals in 2013 of 162 compared with 244 and 289 for the first halves of 2012 and 2011 respectively confirm this, but we await the year end results. The overhang of the financial crisis and certain other factors such as uncertainty created by Solvency II may partly explain this, but the numbers may not tell the full story given our experience in working with and speaking to our insurance clients. There were a number of significant deals in 2013 (some of which we note below) and deal-making by value has increased significantly, even if numbers of deals are down. Furthermore, the nature and types of transactions may represent trends and developments in insurance M&A activity (discussed in further detail below) that could continue and perhaps accelerate in 2014. Indeed, in a recent study by Towers Watson, 69 percent of respondents at insurance businesses said their company plans for some kind of acquisition activity over the next three years, and 77 percent of respondents foresee an increase in M&A activity within that time period. Our discussions with clients certainly reflect that statistic.

Developed markets. In 2013 there was some consolidation in more developed markets, particularly the life sector. This is no surprise given an economic environment where investment returns may not be attractive and companies look to benefit from economies of scale, again particularly the life sector. Feeding this appetite is the trend of European insurers selling non-core US assets as evidenced by Generali Group's sale of its US life reinsurance operations to SCOR Global Life SE and AXA's sale of MONY Life Insurance Company to Protective Life for over US$1 billion.

The Lloyd's market has also been active, with a series of acquisitions of Lloyd's players creating a domino effect, many of which were subject to very competitive auction processes, including Cathedral Capital Limited, Sagicor, Torus and most recently Canopius. Clearly, Lloyd's continues to be a very attractive market, not least for its international reach and profile. Entry by acquisition, rather than start-up, is an appealing route into Lloyd's, particularly for private equity players. However, given the number of deals that occurred in the Lloyd's market last year, there must be a question around the number of suitable targets that are left for acquisition in 2014.

Asia – one size does not fit all. The mature markets have also been the focus for Asian firms (both strategic and investors), with Japan's NKSJ Holdings acquiring the Canopius Group Limited, being a prime example, and most recently Fosun's acquisition of the insurance arm of Portuguese state-owned bank Caixa Geral de Depositos for US$1.36 billion. In our experience, for every completed deal by an Asian company, many more are being considered or attempted. However, these transactions are challenged by price gaps and competitive auction processes, which can lead to a low completion ratio.

As a number of Asian insurance companies look to diversify their books of business or believe that growth opportunities in Asia (or Asia-Pacific) are more attractive, Asia has certainly emerged as a hive of M&A activity.

Where no man has gone before… European or US insurers moving into "growth markets" is a significant theme that has emerged in 2013 and seems set to continue in 2014. International insurance companies appear to be attracted by developing economies and rocketing middle-classes (with increasing personal wealth and disposable income), with distinct cultural shifts in how insurance is viewed by these populations. Hot spots include certain countries in Latin America, Asia and central and Eastern Europe. According to a study by PwC, the Latin American markets are top of the charts, with 88 of 92 respondents citing Latin American countries as key geographies for future growth.

AXA's acquisition of HSBC's general insurance businesses in Hong Kong, Singapore and Mexico is an example of better-capitalized firms taking advantage of the withdrawal of others from such emerging markets. Notably, in some jurisdictions there are further challenges surrounding the quality of data, business practices and local regulations (relationships), but we have certainly seen our clients take an increasingly bold approach to new frontiers, often with a local partner or by way of joint venture, with extensive due diligence and a well thought out and time consuming post-deal integration plan. In the Towers Watson study, 27 percent of respondents said that M&A activity was undertaken for the purpose of entering new geographical markets. It should be acknowledged that many of the largest insurance clients have already taken the plunge in several growth markets, and so in addition to further international M&A expansion, we can expect a period of consolidation in certain markets in 2014.

Solvency II saga. There has been much talk of Solvency II driving M&A activity. Some of our clients have cited Solvency II as a factor in M&A decision making processes. More recently, it has not been a driver, but rather something to be aware of, and some have gone as far as to say that they cannot pay too much credence to Solvency II or make decisions on the basis of it, given the numerous delays and uncertainty as to crucial detail in relation to implementation. This was evident in a recent Deloitte Solvency II Survey, in which only 8 percent of respondents had undertaken M&A due to Solvency II.

An increase in M&A activity would not be surprising, given the recent developments with Solvency II and the progress that now seems is being made in its finalisation, as firms look to increase capital efficiency and gain benefits from favorable diversification treatment. In broader terms, increasing regulatory compliance – while doubtfully a driving factor – is arguably a reason for M&A consolidation, as some companies look to benefit

Whether new investors in ILS – noticeably pension funds, but also now including several publicly traded ILS investors, in various forms, having entered the market for the “alpha” or higher yield in the face of low interest rates – would stay for the “beta” or lack of correlation of the asset class now that yields on ILS have dropped due to the extensive demand

from economies of scale, particularly in the life and broking sectors.

Private Equity, legacy and much more. We have seen considerable private equity interest and activity in the insurance market, with some new comers/first timers looking to invest in the insurance sector, while others are looking to divest in certain markets. In August, ING Group announced the sale of its South Korean life insurance unit to private equity firm MBK Partners for US$1.66 billion. Conversely, a number of private equity houses who are already established in the financial services market are now looking to exit and cash-in on their investments, as was the case in relation to some of the Lloyd’s deals mentioned earlier. The run-off market has also seen some interesting developments as certain European insurers seem to be now better organised and focused on pooling their legacy business and extracting value, whether by divestures (including portfolio/Part VII transfers) or otherwise. Certain run-off players have become more creative in closing deals, moving into the live space and partnering with other firms, such as run-off specialist Enstar Group Ltd together with private equity firm Stone Point, acquiring Torus Insurance Holdings Ltd in order to expand into “live” underwriting and direct sales of coverage.

Insurance M&A in 2014. Is insurance M&A “on the up”? A question that is clearly difficult to answer and will depend on the sub-sector, the region and the type of client, but it seems that the global outlook for insurance M&A for 2014 is positive according to our clients and certain surveys and is supported (or at least suggested) by some of the themes and developments that we saw in 2013 as described above.

Insurance-Linked Securities Trends

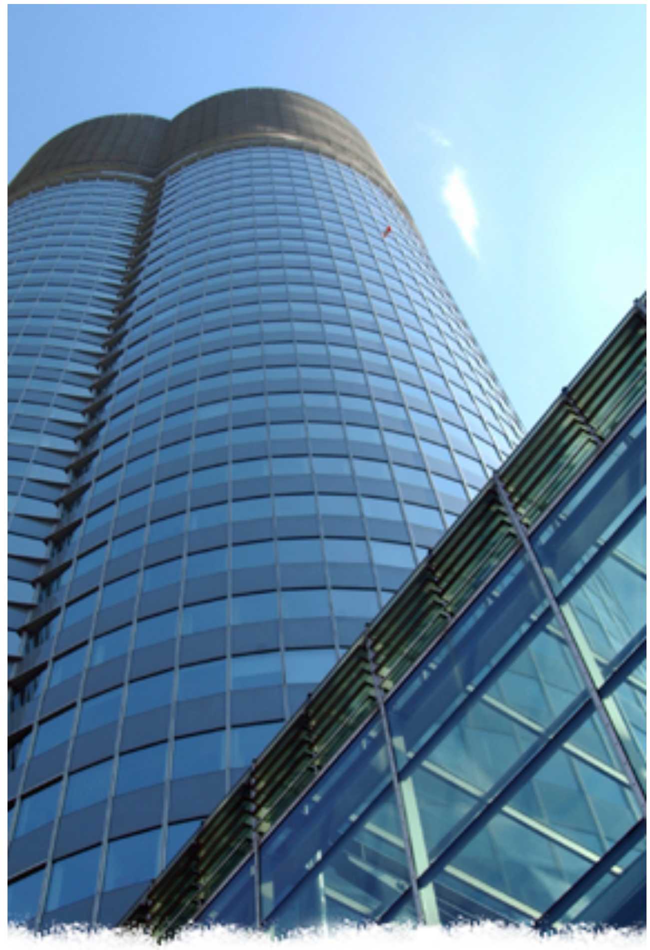
Property and Casualty Insurance Linked Securities. 2013 was a banner year for issuance of insurance linked securities (“ILS”). According to Swiss Re’s published January 2014 market update, 2013 ranked second behind 2007 for overall issuance and first in catastrophe bond (“cat bond”) issuance. Not only did the year-end cat bond issuance total US$20.2 billion, but there was noticeable development in both the size and sophistication of the sidecar and collateralized reinsurance markets. Seven new sponsors issued cat bonds in 2013, noticeably including the Turkish Catastrophe Insurance Pool and the Metropolitan Transit Authority, spot-lighting that “alternative risk transfer” has spread even to quasi-governmental organizations. The concerted weight of this ILS issuance had a noticeable effect on prices, especially at the 2013 year-end renewal season, sparking discussion as to whether this was the “new normal,” or whether the alternative capital entering the (re)insurance market would be able to weather a truly catastrophic event. Further speculation continues on whether new investors in ILS – noticeably pension funds, but also now including several publicly traded ILS investors, in various forms, having entered the market for the “alpha” or higher yield in the face of low interest rates – would stay for the “beta” or lack of correlation of the asset class now that yields on ILS have dropped due to the extensive demand.

At the same time, buyers of traditional reinsurance were seen to exert their market value, and perhaps the superior leverage granted by having an ILS alternative, with many grouping their reinsurers into “tier 1” (aka the Magic Circle) and “tier 2.” This classification, together with the seemingly perpetual soft market, may lead to consolidation, particularly among the smaller reinsurers, as the pressure of the capital markets leads to mergers and acquisitions. Likewise, in the ILS market, ILS issuers continued to obtain better terms in 2013, with a continuing market shift to indemnity rather than parametric or index-based cover. Moreover, particularly in the sidecar and collateralized reinsurance markets, more complex products came to market, which in some ways resemble collateralized debt obligations (CDOs) or collateralized loan obligations (CLOS). Deviating from the standard market practice of investors participating in a defined block of business and relying on a warranty of net retention to ensure that the ILS issuer “ate its own cooking,” these “managed sidecars” allowed ILS issuers discretion in reinsuring different blocks of business. At the same time, dedicated ILS investors (some of them publicly traded) continued to enter the market.

Away from the "traditional" ILS market (if such a term can be applied to alternative risk transfer), interest from hedge funds and other financial institutions in reinsurance continued, highlighted by Third Point Re's initial public offering. With an asset-driven, rather than liability-driven, business rationale almost opposite to the traditional ILS market, this new generation of reinsurers typically eschew higher margin low frequency high severity business (such as property catastrophe) in lieu of higher frequency lower severity business with (hopefully) more predictable loss ratios. While the overall market impact of this type of reinsurer on the reinsurance market is more muted than in the "traditional" ILs market, the "hedge fund" reinsurers – at least one of which is now a "public hedge fund reinsurer" – continue a trend of the capital markets funding (re)insurance in new and novel ways.

Life Insurance Linked Securities. 2013 was another busy year for alternative risk transfer in the life insurance industry. In the US, despite (or perhaps because of) the regulatory scrutiny on special purpose financial captive insurers, financings to fund reserves for term life insurance policies and universal life insurance policies with secondary guarantees flourished. Most noticeably, these financings became integral parts of mergers and acquisitions, with publicly available documents revealing their part in both the Aviva-Athene Re-Global Atlantic transaction and the Allstate-Resolution transaction. Especially given the active role of private equity and other financial buyers in the life insurance M&A market, as opposed to strategic buyers with more ready access to traditional lines of credit, canny acquirers (and sellers) may consider adding reinsurance and structured insurance-linked transactions to their M&A toolkits. For life insurance company sponsors of insurance-linked financings, as in the property/casualty ILS market, 2013 was a year of steadily improving terms and conditions in the market, and increased competition by financing providers. In addition, structured insurance-linked transactions reached beyond term and universal life to other life and annuity products, demonstrating continued innovation in the market.

In Europe, there were a number of value-in-force or embedded value financings as troubled European



insurers, and particularly bancassurers, sought to monetize future profits to shore up their capital base. While many of these transactions were structured as securitizations pre-credit crisis, they now tend to be structured as reinsurance, often with reinsurers partnering with banks to provide the funding required for the transactions, while retaining the insurance risk. Away from insurance, the pension buy-in/buy-out market continued to develop, as pension scheme sponsors de-risked their pension exposures, or at least their longevity risk.

Trends in the Ultra-Specialty Insurance Sector – Smaller Firms that Pack a Powerful Punch

The specialist insurance sector has continued to become more specialized as competition in the sector has grown more fierce. Several smaller specialty insurers that focus on establishing a deep expertise in very specific markets have emerged. These very focused specialty insurers, or ultra specialty insurers, have captured the attention of general P&C insurers, larger specialist insurers and insurance investors. By focusing on niche markets and providing tailored products to specific groups of similarly situated customers, ultra specialist insurers have been able to offer products that better fit the needs of customers. This specialty focus has enabled ultra specialty insurers to quickly grow their customer base – oftentimes at the expense of generalist P&C insurers and other specialized insurers with a less concentrated focus – and more accurately predict the performance of books of business due to the greater uniformity of risks written in the target niche.

Investors took notice of the growth prospects and solid financial performance of ultra specialty insurers in 2013. Attracted by the potential of lower loss and expense ratios, more efficient use of capital and more predictable cash flow streams, both strategic and financial investors explored opportunities to invest in the specialty insurance sector in 2013. DLA Piper's insurance team saw a wide range of activities in the course of our representation of clients involving the specialty insurance sector over the last 12 months, including investors providing fresh capital, acquiring an ownership interest from an existing shareholder and entering into alliances with specialty insurance players, whether through traditional alliance agreements or risk transfer structures.

There was particular investor interest in ultra specialty insurance companies that did not have legacy issues and had assembled teams of underwriters and claims specialists with strong expertise in very specific target niches that were large enough to make sizeable profits but not so large as to incentivize generalist P&C insurers and more general specialty insurers to invest in the resources to compete against the ultra specialist insurers in the selected target niches (at least in the short term). Another trend we observed is that non-US investors, especially those from Asia, saw the North America ultra specialty insurance sector, with its smaller scale and discrete products lines, being perceived as a lower risk way to enter into the US insurance market for the first time. On several of our projects, the specialty insurers also saw an opportunity to expand their geographic reach (while still focusing on specific market niches) by partnering with an international investor that could help open up new markets in the international investor's home market.

One of the key issues in investing in a specialty insurance company, much like a technology company comprised of world class engineers, is retaining, attracting and incentivizing the specialist underwriters, claims personnel and management who have a deep knowledge of the target niche and relationships with brokers and customers that have been developed over many years. From a legal perspective, in addition to the usual legal due diligence of insurance regulatory issues, underwriting procedures, claims practices, litigation, reserving methodologies and similar issues, we also typically spend a considerable amount of time in specialty insurance deals in working with our clients to develop shareholder and management incentive structures that align both investors' and management's/employee's interests. These are usually documented through shareholder agreements providing manager-owners with some influence in conducting the business, employee incentive plans and for key employees, employment agreements.

We believe that the ultra specialty insurance sector will continue to grow and attract capital in the coming years

We believe that the ultra specialty insurance sector will continue to grow and attract capital in the coming years, especially as insurance rates increase and investment yields creep back up, because many ultra specialist insurance companies focus on products that can justify higher prices and have longer lag times between the writing of a policy and payouts. We also expect that as more capital flows into the specialty insurance sector, there will be further pressure to develop even deeper expertise in micro-niches that could erode the benefit of economies of scale, but we also expect that this dynamic will also result in more innovation in the insurance industry as a whole. Another challenge faced by smaller ultra specialty insurers is the impact of regulatory change as discussed in more detail in this Annual Review and Forecast. We are excited to be part of this dynamic sector and look forward to see the ways ultra specialty insurance industry players continue to shape and influence insurance trends in 2014 and beyond.

CONCLUSION

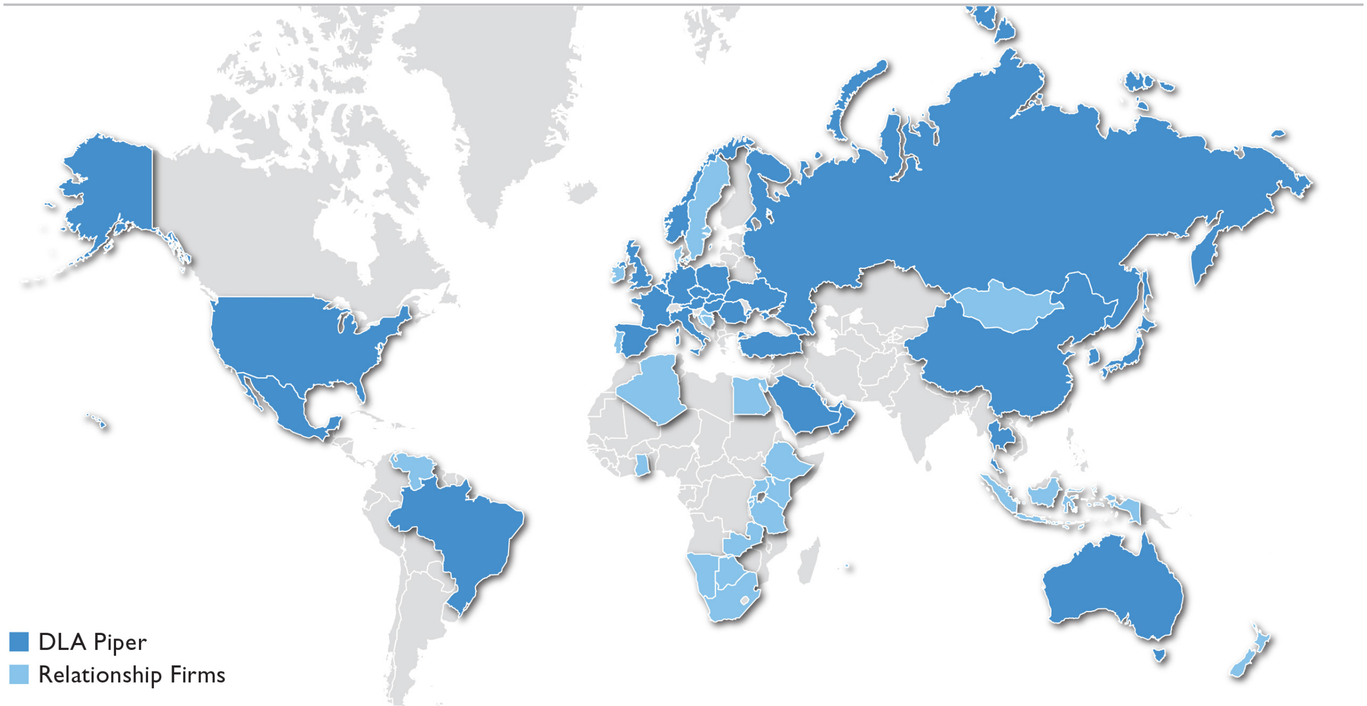
2013 was a year of significant changes and challenges. The numerous regulatory developments internationally and domestically mean the rules of the game (and even the referees) are in flux – and in some critical areas unclear. Undoubtedly, issues such as capital standards, group supervision and harmonization of regulatory standards will continue to dominate regulatory discussions. Insurers, and now third-party capital, meanwhile, will continue to look for top line growth, seek diversification of risks and grapple with the growing convergence of capital markets solutions and traditional insurance. All of this will play out within an uncertain economic climate.

More specifically, in 2014 we will be watching, among many other important developments, the following:

- What significant cross-border transactions will take place? Will it be east to west?
- Will third-party capital continue to encroach on the turf of the traditional industry? What new innovations will take place to help satiate the appetite of these new sources of capital?
- Will the IAIS come up with basic capital requirements by November? Will they apply to G-SIIs only?
- How many reinsurers will be deemed G-SIIs?
- Will cross-border regulation become a reality or remain a goal that nonetheless influences change and the adoption of mirror image prudential measures?
- Will insurance regulation be a key trade issue or negotiation point in 2014?
- Will FIO's role and influence expand or contract?
- Will the NAIC be able to make meaningful progress toward the adoption of principle-based reserving?
- Will a sufficient number of states adopt the NAIC's model insurance holding company and ORSA acts for these measures to become accreditation standards?
- Will the roll-out of the federal exchange and the implementation of other aspects of the Affordable Care Act get back on track?
- What will the mid-term elections mean to the implementation of the Affordable Care Act?

These, and other developments, await the industry in 2014. For our friends in the industry, we hope it is a successful year

OUR GLOBAL PRESENCE



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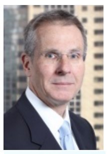
ABOUT US

DLA Piper is a global law firm with lawyers across the Americas, Asia Pacific, Europe and the Middle East. From the quality of our legal advice and business insight to the efficiency of our legal teams, we believe that when it comes to the way we serve and interact with our clients, everything matters

For more information

This publication reflects the work and experience of many within our global insurance team. The principal authors are:



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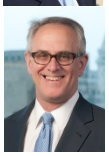

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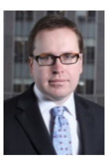

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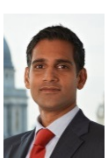

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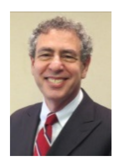

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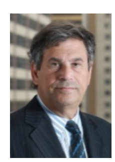

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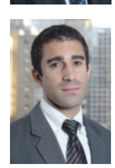

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If you have any questions or comments regarding this *2013 Year End Review and Forecast for 2014*, or would like further information about these evolving areas of law, please let us, or your DLA Piper relationship partner, know.