



## NAIC Report: 2012 Summer National Meeting

August 20, 2012

Insurance regulators and industry representatives descended upon Atlanta, the hometown of *Gone with the Wind* author Margaret Mitchell, for the NAIC's 2012 Summer National Meeting from August 11 to August 14, where most everyone gave a damn about significant emerging issues in state regulation.

Hallway chatter was dominated by the announcement that Terri Vaughan will step down as NAIC Chief Executive Officer next year. Dr. Vaughan has been a forceful presence in helping U.S. regulators articulate justifications for our state-based system of regulation and in shaping the message that the U.S. system does not have to employ methods equivalent to European or international methods in order to achieve positive outcomes. Her efforts have raised the profile of U.S. insurance regulation in Washington, D.C. and Basel. With the announcement of her departure, there was much speculation about who will replace her.

Our report is separated into topics of general interest, followed by topics of particular interest to life insurers and property and casualty insurers, respectively.

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## **IMPORTANT ISSUES OF GENERAL INTEREST**

### **1. “But is it FSAP-able?”**

This meeting marked a new entry in the regulatory lexicon: FSAP-able. This is meant to describe whether a rule or practice is one which is likely to pass muster during the upcoming Financial Sector Assessment Program (FSAP) review of U.S. insurance regulation. The U.S. agreed with the G-20 nations to participate in this program during the financial crisis, and the next assessment is due to be conducted in 2014. Reviewers from the International Monetary Fund (IMF) will assess whether insurance regulation in the U.S. complies with International Association of Insurance Supervisors (IAIS) Insurance Core Principles (ICPs). The last assessment was carried out in 2010 and noted shortcomings in group-wide supervision. The ICPs have been expanded and updated since the last assessment, and regulators here have been working hard to head-off any findings that the U.S. falls short. In Atlanta, different practices or proposals were occasionally described by regulators as being “FSAP-able.”

Highlighting the growing importance of international issues to U.S. state insurance regulators, the opening keynote address to the Summer Meeting was given by Peter Braumüller, IAIS Chairman. In his remarks, Chairman Braumüller emphasized that in recent years we have witnessed not only the increasing globalization of insurance markets but also the intersection of insurance, banking and other finance. He charged U.S. insurance regulators to have a broader understanding of the groups in which regulated insurance entities operate and emphasized they need to be able and willing to share information with regulators in other jurisdictions and other fields.

### **2. ORSA – “A Game Changer.”**

Progress continued on implementing the NAIC’s Own Risk and Solvency Assessment (ORSA) Guidance Manual. Based on the experience the NAIC gained from the ORSA pilot project in which 13 insurers filed confidential draft ORSA Summary Reports, the ORSA Guidance Manual will be revised to require insurers to (1) identify the basis of accounting used for financial data (e.g., GAAP, SAP, IFRS), (2) identify the entities that were included in the ORSA and enclose an organizational chart, (3) include a summary of material changes from the prior year, and (4) provide a review of changes in group risk capital from the prior year.

In addition, the NAIC offered the following advice to those preparing an ORSA Summary Report: (a) engage the Board of the reporting insurer in the ORSA process, (b) fully disclose how compensation and risk relate, (c) provide detail on risk limits, (d) combine stress scenarios to show the simultaneous effect of several stress factors, (e) provide detail on how capital was calculated, (f) include or make available documents referenced in the ORSA Summary Report, (g) provide significant stress testing for liquidity risk (especially by life insurers), and (h) discuss emerging risks in the Prospective Solvency Assessment section.

With regard to the hot topic of confidentiality, the version of the ORSA Model Act adopted by the Group Solvency Issues (E) Working Group reflects a new strong statement of the legislative intent to the effect that the ORSA Summary Report should be kept confidential and not be subject to public disclosures due to the sensitive, proprietary and trade secret information contained in it. In addition, the Model Act’s text from the prior version that would have given state insurance commissioners the right to disclose all or part of an ORSA Summary Report was removed.

*There is still quite a bit of legwork necessary to bring the ORSA to reality, including adding the Guidance Manual as an accreditation standard along with the ORSA Model Act, coordination with Supervisory Colleges in developing best risk practices and clarifying the role of the lead state, modifying the Financial*



*Analysis and Examination Workbook to reflect how ORSA will change the focus of exams, and developing ORSA training and guidance for regulators. But despite the work ahead, the ORSA continues to be a top priority for the NAIC's Solvency Modernization Initiative. This was underscored by comments by Pennsylvania's Steve Johnson during discussion of pilot program results, in which he remarked that once regulators have seen the "best of the best," it would be a "regulatory game changer." In other words, a well-done ORSA will set the standard for what regulators should expect from all other insurers, and this will then become a primary tool for financial oversight and regulation. Mr. Johnson further elaborated that if all goes as planned, the ORSA requirement will "go live" in 2015.*

### 3. Subcommittee on Captive Insurance Debates Reserve Financing

The Captive and Special Purpose Vehicle (SPV) Use Subgroup of the Financial Condition (E) Committee, consisting of representatives of the Financial Analysis Working Group, the Reinsurance Task Force and the Life Actuarial Task Force, continues its work on a White Paper on the use of captives and special purpose insurers. A revised draft of the White Paper was released prior to the Summer Meeting. The draft includes conclusions and recommendations, including the observation that "the majority use of captives/SPVs by commercial insurers was related to the financing of XXX and reserve redundancies." The draft acknowledges there are legitimate business reasons other than statutory accounting relief for the use of a captive or SPV, but stated a preference to see alternative, less costly and more transparent solutions to the issues captives/SPVs were designed to address. Of particular concern is use of letters of credit or parental guarantees to support captives, as well as inconsistency among regulators in what they will approve for the funding of captives/SPVs.

At the Summer Meeting, Subgroup members debated whether captives and SPVs are used to circumvent the reserving requirements of U.S. statutory accounting. Commissioner William White of the District of Columbia observed that alternative risk transfer (ART) techniques have been developed over the past decades, and that regulators should understand the "movement from risk transfer to risk finance." Commissioner White indicated that such an understanding is essential to regulate captives, SPVs and other ART structures onshore rather than drive the ART market offshore. The White Paper will be revised somewhat, and then will be exposed for a formal comment period.

*The recent Section 308 request by the New York Department of Financial Services regarding use of affiliated captives and SPVs by insurers was not mentioned at the Subgroup meeting. The New York Section 308 request could be seen as an attempt by New York to "goose" the NAIC's normal deliberation processes to accelerate and influence increased regulation of captives of commercial insurers.*

### 4. Reinsurance Task Force Puts NRRRA in the Spotlight

The work of the Reinsurance (E) Task Force in Atlanta consisted largely of various and sundry implementation issues presented by the revised Credit for Reinsurance Model Act and Regulation and the Non-Admitted and Reinsurance Reform Act (NRRRA) enacted as part of Dodd-Frank.

Task Force Chair Michael Consedine (Pennsylvania) reported that 10 states representing 40% of the U.S. domestic direct written premiums have now enacted legislation or adopted regulations allowing reduced collateral, although New York and Florida are the only states to have approved "certified reinsurers" that qualify for reduced collateral (a list of certified reinsurers was handed out at the meeting). Commissioner Consedine then reported on work currently underway to develop processes for the review of foreign jurisdictions to be "Qualified Jurisdictions" under the revised Credit for Reinsurance Model Act and Regulation. Steve Johnson reported on work underway to form a Reinsurance Financial Analysis Working Group (Re-FAWG) that would replicate the work of the FAWG in monitoring the financial condition of reinsurers. A working group has prepared a first draft of a Re-FAWG procedures manual, to be ready for wider circulation in the fall.



The Task Force discussed some issues arising out of the NRRA's preemption of extraterritorial application of credit for reinsurance, financial information filing requirements, and certain other aspects of state law with regard to certain reinsurers. New York mentioned that it has "questions" it would like to ask of accredited reinsurers notwithstanding the NRRA, and that it may wish to regulate reinsurance ceded by a New York domiciled insurer to a non-New York subsidiary. In addition, the California Department of Insurance asked the Task Force to consider developing guidance for the definition of "reinsurer" and the meaning of phrases such as "significant amounts of direct insurance" and "soliciting direct insurance" for purposes of having a uniform application of those standards under the NRRA (under the NRRA, only the domestic regulator can regulate the financial condition of a "reinsurer").

Acting on a referral from the Financial Analysis (E) Working Group, a new subgroup of the Reinsurance (E) Task Force was formed to look into whether certain reinsurance contracts referred to by cedents as "quota share" are in substance transferring less risk than is expected in quota share reinsurance. These reinsurance contracts were described as containing "loss corridors, sliding scale commissions and loss caps," without a discussion of these terms. The subgroup will look into whether cedents are transferring less risk under such agreements than is reflected in their financial statements, but where regulators did not think there was an absence of risk transfer. Industry representatives suggested that there may be no need for the NAIC to take any action with regard to such transfers and that this may simply be a compliance issue for a limited number of cedents.

## 5. Corporate Governance "Enhancements" Exposed for Comment

The Corporate Governance (E) Working Group exposed its draft "Proposed Response to a Comparative Analysis of Existing U.S. Corporate Governance Requirements" for a 45-day public comment period ending September 28. Industry groups objected to the proposed establishment of a standardized rating system; however, Deputy Commissioner Susan Donegan of Vermont held fast to exposing the draft, stating that interested parties will have plenty of time to submit comments and recommendations.

In 2011, the Working Group completed a summary of existing corporate governance requirements and practices that affect U.S. insurers. It has also performed a comparative analysis of existing U.S. standards and international standards and practices, focusing on the IAIS ICPs, Australia, Canada, Switzerland, the United Kingdom and Bermuda. Since March of this year, it has been formulating proposed enhancements to U.S. regulation based on this comparison, this by considering each of the core principles set out in the United States Insurance Financial Solvency Framework adopted as part of the Solvency Modernization Initiative in 2010. The product of this work is the "Proposed Response to a Comparative Analysis of Existing U.S. Corporate Governance Requirements," which covers increased reporting as part of the annual statement (including interrogatories on compensation practices and reinsurance strategy), development of standardized review techniques, development of a common methodology for assessing corporate governance and a requirement that life company actuaries report to the board on an annual basis.

## **ISSUES OF INTEREST TO LIFE INSURERS**

### 1. Otherwise Uneventful (A) Committee Meeting Highlights Imminent Federal Regulation

Interestingly given the forum and the continuing tug of war between state and federal regulation of insurance, Commissioner Julie McPeak of Tennessee opened the Life Insurance and Annuities (A) Committee meeting with a report on federal developments: newly released Department of Treasury and Department of Labor (DOL) rules focusing on retirement security, President Obama's endorsement of





annuities, the Harkin Report and expected legislative initiative, and the veterans pension program. Commissioner McPeak also announced a DOL request that the NAIC assist it in crafting a safe harbor for ERISA fiduciaries in selecting an annuity provider for a pension plan. This type of safe harbor would presumably apply to the DOL's "safest annuity available" rule under Interpretive Bulletin 95-1.

What followed was a summary, and adoption, of reports from various working groups, with a number of actions being teed up for the December meeting rather than resolved in August. The Annuity Disclosure Working Group reported that it would have a recommendation for the (A) Committee in December on whether to require separate annuity buyer's guides or a single guide for fixed and variable annuities. However the expectation is that the recommendation will be two separate guides.

## 2. The Road to PBR Implementation

In anticipation of the adoption of the Valuation Manual and the implementation of Principles-Based Reserving (PBR), the New York Department of Financial Services has been conducting a pilot program to highlight potential issues that may be encountered by state departments of insurance in preparing for the submission of experience reporting and the use of a statistical agent under the Valuation Manual. At the Summer Meeting, the Life Actuarial (A) Task Force heard a presentation by Fred Andersen, Supervising Actuary of New York's Life Bureau, regarding the program.

Mr. Andersen reported that the New York pilot program is now in its second data call, which includes the collection of ordinary life product mortality data. The pilot program is expected first to expand to include ordinary life product policyholder behavior (i.e., "lapse") data and then very incrementally to expand to other products. Mr. Andersen pointed out that New York-licensed companies account for between 35% and 40% of U.S. life insurance by premium volume and so a second large state conducting such a program could potentially familiarize almost a majority of the life insurance industry with the experience reporting process. Mr. Andersen also discussed the lessons learned with regard to selection of a statistical agent by the pilot program and hoped to incorporate additional lessons from the RFP process that resulted in the selection of Towers Watson for the NAIC study on PBR.

The Valuation Manual has been on a track for final adoption by year end so that state legislatures can begin work on amendments to the Standard Valuation Law in 2013. It has now been approved by Life Actuarial (A) Task Force and referred to the Life Insurance and Annuities (A) Committee. However, in what was described as "late-breaking news," consideration of the Valuation Manual was deferred for further discussion, and a conference call was scheduled for August 17 – *where the Valuation Manual was subsequently approved, with only New York dissenting*. During the earlier meeting of the Principles Based Reserving (E) Working Group, representatives from the American Academy of Actuaries provided a presentation on the need for a process to review the prescriptive and limiting elements of PBR it views as potentially undermining the benefits to be achieved from the principles-based approach as compared to the current strictly formulaic basis for setting life reserves. Academy representatives said that while the Academy supports the adoption of PBR, it would not be prudent or responsible to establish a stochastic valuation requirement without also establishing a process that facilitates the ongoing review, assessment and improvement of the methodology. These comments were echoed by the American Council of Life Insurers (ACLI), which in July submitted comments that there are elements of PBR that need to be reviewed prior to implementation, including processes for making changes to the Manual. This prompted Commissioner Susan Voss (Iowa) to demand a loyalty oath – asking the ACLI to declare whether it is for or against PBR. The ACLI, in turn, urged the NAIC to act promptly on the issues it presented so that PBR will be ready for roll-out by year end.

*The NAIC has been working on a principles-based approach to determining life insurance reserves since 2005. Work has been consistent, but slow, and the NAIC's original time frame for adopting PBR has been reset repeatedly. Industry comments show reservation with implementation of PBR as it has*



emerged, and the New York experience reporting pilot project is probably the first of a number of attempts to understand the technical implementation hurdles that stand between adoption and full implementation of the Manual.

### 3. Contingent Deferred Annuity Supporters Respond to Criticism and Concerns

Prior to promising recommendations by December at the Life Insurance and Annuities (A) Committee meeting, the newly formed Contingent Deferred Annuity (A) Working Group held a second public meeting, following an interim meeting held on June 27, 2012, in Washington, D.C. The first meeting heard testimony from federal authorities, including the GAO, SEC and FINRA, as well as from industry representatives and the American Academy of Actuaries. While the Working Group meeting held at the Summer Meeting also heard testimony from industry representatives, the meeting began with testimony from Birny Birnbaum of the Center for Economic Justice taking up the standard of a consumer representative. Mr. Birnbaum claimed that contingent deferred annuities (CDAs) involve risks highly related to market variation, which leads to uncertainty in setting adequate reserves for such products and results in the concentration rather than distribution of risk.

Coming to the defense of CDAs, which the NAIC only recently concluded could properly be sold by life insurance companies, industry representatives from Prudential, Transamerica and Great-West testified that the experience of the life insurance industry in offering variable products more than sufficiently prepares it for any challenges associated with calculating adequate reserves for CDAs. This led to a lengthy discussion of the appropriate classification of CDAs as fixed versus variable products. Regulators also expressed concerns with suitability for consumers, including those in ERISA plans managed by a trustee, as well as with the agency and fiduciary duties involved in product distribution. The meeting concluded with a presentation by the DOL regarding its “Lifetime Income Initiative” and the results of its studies carried out under this initiative.

*Although the Contingent Deferred Annuity (A) Working Group is still in its information-gathering stage, the Working Group timeline contemplates the swift drafting of recommendations regarding the adequacy of existing laws and regulations as applied to contingent deferred annuities and whether additional solvency and consumer protection standards are required. According to the timeline, draft recommendations are anticipated to be released for public comment as early as the second week of October for a two week comment period before a release of final draft recommendations to be considered at the Fall NAIC conference.*

## **ISSUES OF INTEREST TO PROPERTY AND CASUALTY INSURERS**

### 1. Lender-Placed Insurance is Topic of Public Hearing

At a public hearing held on August 9, before the official opening of the Summer Meeting, regulators not only heard concerns of consumer groups relating to the practices of creditor-placed property insurers, specifically with regard to rates and expenses, but also voiced some of their own concerns, including the use of surplus lines insurers and retroactivity of cover. Industry representatives responded by citing the uniqueness of the market, which lacks individual risk underwriting and the ability to spread risk geographically, thus substantially heightening its vulnerability to catastrophic losses. Actuarial experts on both sides provided support for, and arguments against, the rate setting and reserving practices of insurers writing lender-placed products. The complexity of these products and their importance in the nationwide mortgage market was also discussed. Industry representatives urged the panel of state regulators not to act hastily in response to unsubstantiated concerns without fully understanding the consequences any such actions may entail.



After the hearing, NAIC President Kevin McCarty of Florida told reporters that the focus of insurance commissioners would be on rates.<sup>1</sup> The next day, the Florida Office of Insurance Regulation (OIR) denied Praetorian's requested statewide decrease of 2.2% in the rate filing for its property collateral protection program, a lender-placed insurance product. According to a press release issued by the Florida OIR, "The Office's indications demonstrated a reduction of 35-36% was required."

*In the long run, state insurance regulatory action may yield to federal regulation in this area. On August 10, the day after the NAIC hearing, the Consumer Financial Protection Bureau, a creation of the Dodd-Frank legislation which endowed the agency with authority to address perceived failures in the mortgage and homeowners markets, released two sets of proposed rules governing the operation of mortgage servicers. Among other things, the proposed rules would require servicers to give advance notice and pricing information before charging consumers for lender-placed insurance.*

### **Briefly Noted**

- **Holding Company Act Amendments Lament**

While chairing the SMI (E) Task Force, Director John Huff of Missouri gently expressed disappointment that only nine states have adopted the new NAIC Model Holding Company Act and encouraged other states to adopt the amendments in the 2012-2013 session. During an earlier meeting, it was reported that the amendments have been fast-tracked for consideration to be included in the NAIC's accreditation standards; that is, included in the list of laws and regulations that a state must adopt in order for its insurance department to remain accredited by the NAIC.

- **Adjuster Licensing – No Carrot, No Stick**

In the same vein, regulators at the Producer Licensing (EX) Task Force and Working Group called for state adoption of uniform standards for adjuster licensing. The group cited designation of home state and emergency adjusters as issues that need to be resolved but state regulators have not been motivated to deal with the problem. Regulators also pointed out that one reason adjuster licensing uniformity has lagged behind producer licensing is that no federal incentive has been created to prompt the states to achieve uniformity.

- **Viatical Settlements Working Group–Revived Lazarus-like From Among the Dead**

The Sunday Executive (EX) Committee decision to direct the Life Insurance and Annuities (A) Committee to discontinue work on the 2012 charge related to the work of the Viatical Settlements (A) Working Group was canceled out by a motion adopted by the joint Executive Committee and Plenary session to reinstate the charge and the Viatical Settlements Working Group. After some had cited the need to prioritize resources, Iowa committed to provide the Working Group with the resources necessary to complete its charge.

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<sup>1</sup> B. Shrestha, "NAIC's Force-Placed Market Inquiry Will Focus On Rates", *Law360* (August 9, 2012).



*If you have any questions about this Legal Alert, please feel free to contact any of the attorneys listed below or the Sutherland attorney with whom you regularly work.*

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