Client Update
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Client Update
NAIC 2017 Spring National Meeting

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The National Association of Insurance Commissioners (NAIC) held its 2017 Spring National Meeting from April 8 to 11, 2017 in Denver, Colorado. This client update highlights some of the developments from the Spring National Meeting that are of particular interest to many of our insurance industry clients, including developments relating to:

For purposes of this report:

- "ACLI" means the American Council of Life Insurers.
- "ComFrame" means the Common Framework for the Supervision of International Active Insurance Groups.
- "EU" means the European Union.
- "FIO" means the Federal Insurance Office of the U.S. Department of the Treasury.
- "FSB" means the Financial Stability Board.
- "G-SII" means a global systemically important insurer.
- "IAIS" means the International Association of Insurance Supervisors.
- "IMF" means the International Monetary Fund.

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

(1) LIFE INSURER DEVELOPMENTS

Principle-Based Reserving

The **Principle-Based Reserving Implementation (EX) Task Force** met for its first in-person meeting since PBR went into effect on January 1, 2017. PBR has a three-year phase-in period, and according to survey data the NAIC has collected, about 16 companies have indicated that they will implement PBR in 2017, although the number may decrease due to the significant systems changes that companies require to implement PBR. The NAIC estimates that about 135 companies will submit PBR valuations in 2020.

The chair of the **Principle-Based Reserving Review Working Group** presented a report of the PBR Company Pilot Project in which 11 companies participated. Term life and universal life with secondary guarantee product lines were tested in the pilot. Several issues that arose with respect to the pilot were noted. First, the report notes that that the level of detail presented in the PBR actuarial report varied significantly, but that regulators believed that companies should provide more detail describing how each company meets the requirements of a principle-based valuation. Second, the report notes that two of the ten companies testing term products had a negative Deterministic Reserve, which indicates that cash inflows from investment income and expected gross premiums are more than sufficient to pay all claims and expenses associated with the product. Such a result could be the result of a well-priced product or an overly aggressive mortality assumption, so understanding the cause of such a result will be a critical exercise for regulators. In addition, one company reported a pre-reinsurance ceded reserve that was less than the post-reinsurance ceded reserve. NAIC staff will review the reinsurance accounting rules to determine if any changes in statutory accounting rules are needed to address this possibility.

A drafting group is using input from the pilot project to update the VM-20 Reserve Supplement and the VM-31 PBR Actuarial Report Requirements to provide additional guidance and clarification, which changes are expected to be developed by this summer. One particular area of focus is the mortality assumptions and the processes used to determine company credibility.

NAIC staff continue to build competencies related to PBR and have started sensitivity testing on the NAIC's PBR calibration model. Results from the sensitivity testing are expected to be presented at the NAIC 2017 Summer National Meeting.

The Task Force heard an update from the **Life Actuarial (A) Task Force** (LATF) on its PBR-related work. LATF has exposed a number of revisions to the Valuation Manual for a 21-day comment period ending May 1, 2017. In addition, LATF adopted VM-22 Maximum Valuation Interest Rates for Income Annuities, which provides the methodology for determining a reserve interest rate that is more responsive to the current low interest rate environment for annuities than the current methodology, and will go into effect January 1, 2018.

Suitability in Annuity Transactions

The **Annuity Suitability (A) Working Group** met for the first time at the Spring National Meeting and discussed its charge to review and revise, as necessary, the NAIC Suitability in Annuity Transactions Model Regulation and to consider how to better promote uniformity across jurisdictions in the area of annuity suitability. The Working Group noted that the Model Regulation was last revised in 2010 to (1) clarify that the insurer is responsible for compliance with the model requirements, even if the insurer contracts with a third party, (2) require the review, in a manner that the insurer considers appropriate, of all recommended annuity transactions to help ensure suitability at the time of sale and (3) establish general and product-specific training for insurance producers. Forty-one states have adopted the 2010 version of the Model Regulation.

The members of the Working Group explained that the time may be right for revisions to the Model Regulation because under current rules, most unsuitable sales go undetected and there is an increasing number of potential annuity customers resulting from the aging of baby boomers. At the same time, annuity products are becoming increasingly complex and may require additional disclosures about more product features. The Working Group heard presentations on its proposed work from the perspectives of insurers, producers and consumers, and discussed potential alternative standards that are higher than "suitable," such as the fiduciary standard proposed by the U.S. Department of Labor for ERISA plans, or a "best interests" standard.

Reinsurance

The **Reinsurance (E) Task Force** heard a report from the **Reinsurance Financial Analysis Working Group** about the certified reinsurer and passporting processes. Working Group members noted the importance of educating regulators as to the comprehensive review that each certified reinsurer undergoes so that other states can rely on that analysis.

The Task Force exposed the revised Uniform Application Checklist for Certified Reinsurers for a 30-day public comment period ending May 8, 2017. The revised checklist now includes a protocol for considering a group rating.

The Task Force received a status report on the implementation of various model laws and regulations. The revised Credit for Reinsurance Model Law has been adopted by 39 states, and the revised Credit for Reinsurance Model Regulation has been adopted by 28 states, covering more than 70% of direct insurance premium written across all lines of business. Several states, including Texas and Illinois, are considering the adoption of the models, which would substantially increase the premium volume covered. In addition, nine states have adopted the 2016 revisions to the Credit for Reinsurance Model Law. Task Force members noted that the Model Law is applicable to reinsurers throughout the world reinsuring business of U.S. companies, so states should not delay adopting the models while waiting to understand the impact of the U.S.-EU Covered Agreement, which only covers reinsurers domiciled in the EU.

Surplus Note Accounting

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

The proposed amendments were exposed for comment until May 19, 2017 and are expected to be discussed by the Working Group during a conference call in early June.

(2) PROPERTY/CASUALTY INSURER DEVELOPMENTS

Big Data

The **Big Data (EX) Working Group** heard a presentation on "Big Data and Regulation in the Insurance Industry" from Professor Lawrence S. Powell, Executive Director, Alabama Center for Insurance Information and Research, University of Alabama. Professor Powell highlighted some of the potential benefits of using Big Data in the insurance sector, including more accurate pricing, the use of more predictive rating variables and efficient risk-taking. The report also identified other beneficial uses of Big Data, such as increasing customer satisfaction through the use of real-time monitoring of customer complaint calls, increasing overall insurance coverage with better models and more granular underwriting, and improving accuracy and increasing efficiency by providing insurance quotations using pre-populated information.

Consumer advocate Birny Birnbaum and some Working Group members disagreed with many of the report's findings and conclusions and pointed out that the report was funded by the insurance industry. Rather than reducing their oversight, Mr. Birnbaum suggested that regulators should closely supervise the use of Big Data in order to prevent, for example, using increased granularity in underwriting as a new proxy for discriminating against protected classes. The tone of the back-and-forth at the meeting was more aggressive than is typical at these meetings, suggesting that this will remain an important issue for the NAIC and state regulators.

Sharing Economy

The theme from the meeting of the **Sharing Economy (C) Working Group** was that the sharing economy is a growing market with specific challenges but also with potential for profit. Insurers wishing to enter the market must develop products that meet customer needs while ensuring continued insurer viability. Regulators, on the other hand, must understand consumer protection issues and maintain adequate resources to respond to this developing market.

The Working Group received a report from NAIC staff about the status of state laws authorizing Transportation Network Companies (TNC). The report noted that all states except Vermont, Connecticut, Florida, Oregon, Alaska and New York had laws addressing insurance coverage issues for TNCs. Generally, state laws require the driver, the TNC or both to obtain and retain insurance coverage at various levels in accordance with statutory requirements.

New York adopted TNC legislation in April, which authorizes TNCs to operate in upstate New York. Under the new law, TNCs will be required to maintain a minimum insurance coverage level of $1.25 million while a TNC driver is traveling to pick up a passenger and until the drop-off is completed.

The Committee also received a report regarding insurance products for the sharing economy. Presenters stated that the sharing economy relies on a technology platform base and predicted that this base will have transformative effects on the health care industry. Presenters highlighted insurers' various investment strategies for participation in the sharing economy, including purchasing of digital direct-to-consumer providers, developing innovation centers and assisting startups to develop business models in exchange for potential profits. The report concluded that most products will be developed in the surplus lines market due to difficulties in obtaining model law acceptance under the 50-state system. The Committee also noted that greater consumer education and additional regulator training may be required to handle complaints specific to this new industry.

(3) CYBERSECURITY

The NAIC restructured its technology working groups and task forces. It created a new Innovation and Technology Task Force under the Executive Committee, and put the Big Data Working Group, the Cybersecurity Working Group (formerly called the Cybersecurity Task Force) and the Speed to Market Working Group under the Innovation and Technology Task Force, which met for the first time at the Spring National Meeting.

The Cybersecurity (EX) Working Group

The **Cybersecurity Working (EX) Group** discussed the third draft of the NAIC Insurance Data Security Model Law and heard a presentation from New York Superintendent Maria Vullo on New York's recently adopted cybersecurity regulation.

Superintendent Vullo discussed the New York cybersecurity regulation and the process that New York followed in issuing it. Superintendent Vullo stressed the need to engage with all stakeholders and to be responsive to comments that are received as part of the rulemaking process. She also pointed out that there is no one-size-fits-all solution to cybersecurity and measures should be based on a risk analysis performed by and tailored to the risk profile of an institution.

Despite the need for risk-based flexibility in designing a cybersecurity plan and program, Superintendent Vullo expressed the need for certain minimum requirements, including performing regular risk assessments and having adequate staff with access to the board of an institution. Other minimum standards include ensuring that vendors have adequate cybersecurity, providing notice to the regulator after a known material breach, documenting any weaknesses and regularly certifying compliance.

Superintendent Vullo also discussed differences between the New York regulation and the NAIC draft and responded to questions from the Working Group. Part of the presentation was intended to suggest that the Working Group consider using the New York regulation as a model to emulate or work from. The Working Group discussed potentially incorporating elements from the New York regulation as it continues to work on the Insurance Data Security Model Law. The Working Group also raised the possibility of bifurcating the Working Group's efforts to revise the model to focus first on the preventative measures, about which there is greater agreement, and then turn to breach response requirements.

(4) INTERNATIONAL INSURANCE ISSUES

U.S.-EU Regulatory Relations

Several NAIC committees and task forces heard updates on the U.S.-EU Covered Agreement (Agreement), which affects three areas of prudential insurance supervision: group supervision, reinsurance and information sharing between U.S. and EU regulators. The Dodd-Frank Act authorized the Treasury Secretary and the U.S. Trade Representative to negotiate a covered agreement, which has to be submitted to Congress for review. The first negotiated covered agreement under the law was submitted to the relevant congressional committees on January 13, 2017. The Dodd-Frank Act also provides that 90 days must elapse before the Agreement can enter into force, but questions remain concerning whether the Agreement is self-executing after the 90-day period or whether the Treasury Secretary would have to sign the Agreement for it to be effective. The Department of the Treasury is in the process of evaluating the agreement and receiving feedback from stakeholders. The NAIC has expressed the view that after the 90-day period, the Treasury Secretary has discretion to not execute the Agreement.

The NAIC believes that the Agreement raises numerous substantive and procedural concerns and that further clarification is required before the Agreement can be finalized. For example, the NAIC has sought clarification of whether the group capital calculation under development by the **Group Capital Calculation (E) Working Group** satisfies the Agreement's requirements. The

NAIC is also concerned that the Agreement seems to contemplate ongoing renegotiation of the Agreement's terms and that there is no assurance that state regulators will be represented on the negotiating committee.

The **Reinsurance (E) Task Force** also discussed certain concerns, including the Agreement's elimination of collateral requirements for European reinsurers assuming business from the U.S. Task Force members noted that the ability to require collateral may result in the imposition of alternative protections, such as capital charges. The Task Force indicated that it will not move forward at this time with implementation of the Agreement while it awaits resolution on the NAIC's outstanding questions and further information on the Treasury's position. The Task Force received a report from the **Qualified Jurisdiction (E) Working Group**, which noted that it was in the process of considering the qualified jurisdiction status of France, Germany, Ireland and the United Kingdom, but will not move forward with any public recommendation at this time to avoid interfering with the NAIC's broader position on the Agreement.

IAIS Activities

The **International Insurance Relations (G) Committee** heard a report on IAIS activities. The IAIS is in the process of conducting its fifth assessment of G-SIIs. Fifty insurers, of which 16 are U.S. insurers, are participating in the data collection process. The IAIS has formed a new group, the Systemic Risk Assessment Task Force, which will build on the work of the Non-Traditional and Non-Insurance task force and revisions to the G-SII assessment methodology to create a holistic framework for systemic risk assessment and measurement.

In addition, in March, the IAIS released a number of new and revised Insurance Core Principles and ComFrame principles for a 90-day consultation, which ends June 1, 2017. NAIC working groups are drafting the NAIC's responses to the consultations. The Committee expects to hold a conference call on May 30 to review and approve the submission of the comments. The IAIS expects to release its Insurance Capital Standard 1.0 for extended field testing in early July 2017, and it continues to seek additional field testing volunteers.

The IAIS has recognized that it needs to further engage with regulators in emerging markets and will assess the ways in which it can do so effectively. Finally, Jonathan Dixon of South Africa, the Financial Services Board's deputy executive officer for insurance, has been named the next secretary-general of the IAIS. Mr. Dixon will begin his position in November 2017.

(5) GROUP-WIDE SUPERVISION

Group Capital

The **Group Capital Calculation (E) Working Group** continued to work through issues related to its development of a methodology for calculating group capital. The Working Group heard a presentation from the ACLI on three potential ways to treat non-insurance entities in the calculation. Each proposed methodology would exclude all non-financial entities and all immaterial entities from the calculation unless such entity has demonstrable recourse, such as a guarantee, to the group. These excluded entities would be subject to a qualitative assessment similar to ORSA that would provide regulators with an understanding of the entity's activities and risks.

The first approach is similar to the Federal Reserve Board's Aggregation and Calibration approach. It generally treats insurance-related entities under their parent solvency regime (such as U.S. RBC) and applies sectoral regimes to entities subject to such a regime (such as Basel III for banks). A primary difference from the Aggregation and Calibration approach is that a captive would be assessed under its local solvency regime, rather than its parent's regime.

The second approach is largely similar to the NAIC's mooted approach, which uses the existing sectoral regime for entities subject to such a regime, and for those not subject to such a regime, sets forth a 22.5% U.S. RBC charge for any such material financial services entity and any such non-financial services entity. However, the ACLI proposal suggests a materiality threshold that eliminates from the calculation any non-financial services entities with no demonstrable recourse to the group except for subsidiaries of an insurer and any entities performing activities for the benefit of an affiliate insurer.

The third approach is similar to the first approach but uses only one materiality threshold. A key aspect of the first and third ACLI proposals is that the treatment does not change based on where the entity is placed within the group's corporate structure. The ACLI presenters emphasized the need to conduct extensive field testing on all three proposals. NAIC staff will next create a framework for the three approaches that can be used with company data to compare the approaches.

The Working Group exposed for a public comment period a memo first presented at the NAIC 2016 Summer National Meeting that addresses the proposed treatment for U.S. insurers that are not subject to RBC requirements and U.S. captive insurance companies, permitted practices and certain adjustments to GAAP. Comments on the memo are due by May 26, 2017. The Working Group will hold its next conference call on April 28, 2017.

(6) CONSUMER PROTECTION ISSUES

Market Conduct Accreditation

During the 2016 Summer National Meeting, the **Market Regulation and Consumer Affairs (D) Committee** discussed adopting a Market Regulation Certification Program, which was intended to establish an accreditation or certification program in market conduct regulation for the states, similar to the existing accreditation program for financial examinations. At the 2017 Spring National Meeting, the Committee adopted a two-year pilot program to implement a Voluntary Market Regulation Certification Program, which will include market conduct standards reflecting state statutory authorities and staffing resources as well interstate collaboration through participation in NAIC market regulation working groups and use of NAIC market information systems.

The pilot program seeks 12 states to volunteer for 2017, with an additional six jurisdictions to volunteer in 2018. Participating states would receive $5,000 annually to assist with implementation of the program and are expected to assist the NAIC in drafting an annual report describing improvements in compliance and issues associated with obtaining full compliance.

The main concern voiced by some Committee members was whether this voluntary program will one day become an accreditation standard. The Committee chair stated that the reason for the pilot program is to assess potential impacts before making a decision about accreditation.

(7) VALUATION OF SECURITIES TASK FORCE

Proposed Amendments to the Purposes and Procedures Manual

At the 2016 Spring National Meeting, the **Valuation of Securities (E) Task Force** received a report from SVO staff on a project that sought to understand why a large volume of securities (totaling more than $100 billion) fall into an "exception category," i.e., are reported as rated by one or more credit rating providers but are not in the data feeds provided to the SVO by the credit rating providers. The report presented six primary exception categories and recommendations for each. The largest category of exceptions related to private letter rating securities, for which the report recommended that insurers file evidence of a monitored private letter rating or file the security with the SVO for an NAIC designation. Another exception category relates to securities that are shown on the Nationally Recognized Statistical Rating Organizations' websites as rated but do not include a valid identifier or are not included in the credit rating provider data feeds with a valid identifier. The report recommended that the Purposes and Procedures Manual of the NAIC Investment Analysis Office (P&P Manual) be amended to consider a security not found on NAIC systems to be not rated and to require that the security be filed with the SVO.

At the 2016 Fall National Meeting, the Task Force adopted a report of the **Reporting Exceptions Analysis (E) Working Group** and determined that effective July 1, 2017, insurers would annually confirm the credit rating assigned to securities subject to private rating letters by filing a copy of the rating letter with the SVO pending an agreement by credit rating providers to provide them as data to the SVO in an electronic data feed. Eligible credit ratings verified by the SVO would be converted to NAIC designations in the valuation of securities process and the insurer would file unverified securities with the SVO for analysis or take a 5 or a 6 designation.

Since that time, NAIC staff had been working on amendments to the P&P Manual, which the Task Force exposed after a February 22, 2017 meeting. The intent was for the amendments to be adopted at the 2017 Spring National Meeting with an effective date of July 1, 2017. Among the changes was a proposal that would grant the Investment Analysis Office (IAO) discretion to ignore private letter ratings by credit rating providers and potentially re-rate private placements at a later time, with no right of appeal by the affected insurer. Another source of concern was the IAO's proposal to no longer rate affiliate securities, which could have resulted in a security from a single issuer having one rating if it is held by a non-affiliate, and no rating (or a NAIC 5 or 6 rating) if held by an affiliate.

The Task Force received comments critical of the proposed amendments from a number of interested parties, including a letter signed by six insurance industry associations. The Task Force announced that rather than adopting the amendments to the P&P Manual at this meeting, it will work with the SVO and interested parties to discuss the proposed amendments over the course of 2017, with a projected effective date in 2018. The Task Force decided to draft a short document discussing proposed amendments to the P&P Manual, including the treatment of inter-affiliate securities and the level of discretion that the SVO should have, and will continue to discuss these issues at the Summer National Meeting.

(8) FINANCIAL STABILITY TASK FORCE

Macro-prudential Monitoring

The **Financial Stability (EX) Task Force** heard a presentation about macro-prudential monitoring and group supervision from Mark Grier, Vice Chairman of Prudential Financial, Inc.; John Hele, Chief Financial Officer of MetLife, Inc.; and Tom Wilson, Chief Risk Officer of Allianz SE.

Themes of the presentation included (1) the self-interest insurance companies have in ensuring they are subject to effective, transparent regulation, (2) extending the existing state regulatory environment into a more comprehensive system of group supervision in order to balance the international and federal focus on a group approach with the state legal entity-focused approach, (3) the need for companies to conduct internal monitoring and stress testing to supplement regulatory requirements and (4) the need to develop tools to assess industry-wide risks.

The latter point, also referred to as an activities-based approach, was the subject of a presentation to the **International Insurance Relations (G) Committee** by Mr. Hele and Mr. Wilson. An activities-based approach focuses on improving financial stability by considering the risks created by the systemic activities of all insurers. Certain regulators expressed concerns about the impact on small and mid-sized insurance companies. Roy Woodall, who is the independent member with insurance expertise on the Financial Stability Oversight Council (FSOC), noted that the Dodd-Frank Act permits FSOC to use an activities-based approach in determining threats to financial stability, and it has powers beyond designating insurers as systemically important, including making recommendations to Congress and regulators.

(9) CORPORATE GOVERNANCE

Corporate Governance Annual Disclosure

The **Financial Regulation Standards and Accreditation (F) Committee** discussed comments it received concerning whether to add to the Part A: Laws and Regulations Accreditation Standards (Part A Standards) a requirement to comply with the Corporate Governance Annual Disclosure Model Act and the Corporate Governance Annual Disclosure Model Regulation, which an increasing number of states have adopted. Additionally, the Committee discussed comments related to revisions to the Annual Financial Reporting Model Regulation (Model Audit Rule) as a possible addition to the Part A Standards. Neither proposal elicited concerns from interested parties.

Enterprise Risk Report (Form F)

The **Group Solvency Issues (E) Working Group** continues to explore ways to provide appropriate guidance to regulators and companies related to the Enterprise Risk Report (Form F). At the 2016 Summer National Meeting, the Working Group reviewed results of a survey distributed to NAIC members in assessing the effectiveness of the Form F reporting process. The survey revealed states' dissatisfaction with the Form F process. To address these concerns, the Working Group asked the NAIC staff to draft a non-authoritative guidance manual to provide interpretive guidance on regulator information reporting expectations. An initial draft of the guidance was introduced to the Working Group on October 28, 2016 and exposed for comment.

At the 2017 Spring National Meeting, the Working Group determined that, based on NAIC staff research, the proposed Form F implementation guide exceeds the scope of the Insurance Holding Company System Regulatory Act and the Insurance Holding Company System Model Regulation. As a next step, a drafting group intends to draft a chart comparing requirements under ORSA and Form F. However, Working Group members suggested that some problems with the quality of responses stem from the definition of "enterprise risk" and noted that if the Model Act were to be reopened for another purpose, the Working Group might consider modifying the definition.

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Please do not hesitate to contact us with any questions.