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Insurance Industry Group: Global Corporate Insurance & Regulatory Bulletin

UK – Lloyd's of London publishes new strategy for 2011-2013

On 6 December 2010, Lloyd's of London published its new strategy for the period of 2011-2013. The strategy document contains a plan for Lloyd's major areas of activity for the next three years together with a specific one year plan of actions for 2011. Both elements are aimed at meeting Lloyd's vision "*to be the market of choice for insurance and reinsurance buyers and sellers to access and trade specialist property and casualty risks*". The strategy document is made up of four sections which look at Lloyd's competitive environment, vision, strengths and areas of focus. Each of these sections is looked at below in greater detail.

1. **Competitive environment -** The overview of Lloyd's competitive environment states that *"the overall economic outlook is characterised by a lack of confidence in the future and the sustained demand, and growth, needed to remedy this are unlikely to appear in the short term"*. The strategy document highlights that the global insurance industry faces, amongst others, the following specific pressures:

   – **Impact of economic conditions** – the full impact of the recent economic turmoil and the associated recession-related claims remains to be seen. Investment returns and demand also remain suppressed;

   – **Impact of underwriting conditions** – the strategy document highlights that underwriting conditions remain soft with no strong drivers for change. Amongst the main reasons for this is the amount of excess capital in both primary and reinsurance markets;

   – **Regulatory change** – major changes to the regulatory environment are underway. The UK insurance industry must deal with the adoption of Solvency II, together with the new national UK regulatory environment (following the announcement to disband the FSA) and the creation of a new European regulatory authority (the EU Insurance and Occupational Pensions Authority);

   – **Changing business flows –** although London remains the world's largest international insurance market, regional insurance hubs are becoming more important. In response, both insurers and brokers are increasing their global footprints in order to increase the amount of business they have access to;

   – **Insurers' business models –** Lloyd's notes that the number of competitive challenges it faces regarding insurers' business models includes the increased interest in low tax jurisdictions, such as Switzerland, as a choice of domicile and the possible revival of the New York Insurance Exchange;

   – **Brokers' business models –** the strategy document highlights that *"brokers are facing challenges as soft market conditions and increasingly demanding clients put pressure on their revenues"*; and

- **Changing risks and products** – the strategy document notes the challenges faced by insurers regarding the ongoing changes in the underlying risk landscapes, in particular, the increased severity of both natural and man-made disasters caused by such factors as increased urbanisation, climate change and terrorism.

2. **Vision** - Lloyd's vision, as stated above, remains unchanged from last year. Lloyd's key characteristics, helping it to be the market of choice, are the Lloyd's model (a subscription market backed by a layer of mutual security), being a broker market (in which brokers continue to access the market on behalf of their clients), being a London-based international business, and maintaining diversity (including diversity in the market portfolio and in the size and structure of market participants and capital providers).

3. **Strengths –** The strategy document contains a summary of Lloyd's perceived strengths and, in relation to certain points, a list of any further actions required to support their further development. These can be summarised as follows:

   - **Market oversight** - Lloyd's has endorsed a new risk governance structure overseen by the Franchise Board, established in 2003, which aims *"to work with the market to maintain underwriting and claims discipline and to help manage the performance of Lloyd's businesses over the insurance cycle"*. Individual insurance companies retain primary responsibility for the management of their businesses and should be guided by the performance management framework. The strategy document states that the Franchise Board believes that the Corporation needs to emphasise its challenging business partner role and work with managing agents to check that: (1) for each line of business each year that there is a reasonable expectation of making a gross underwriting profit; and (2) any losses to the central fund are within Lloyd's risk appetite;
   - **Brand and reputation** – Lloyd's believes that its brand, seen as traditional, entrepreneurial and dependable, with excellent financial security, is in a strong position. However, Lloyd's highlights the importance of protecting its brand from contagion (stemming from negative perceptions of the wider financial services industry) and dilution (from the actions of managing agents seeking to grow their own brands). With regard to the first risk of contagion, Lloyd's states that it will continue with its wide range of activities (e.g. lobbying, participation in industry studies, etc.) to differentiate insurance, specifically Lloyd's, from banking;
   - **Access to business** – Lloyd's identifies the ability to access specialist property and casualty (re)insurance business as one of its principal strengths. It is also noted that the Lloyd's international licence network and London location provide access to significant flows of specialist (re)insurance business for market participants. In order to maintain this strength, Lloyd's plans to continue to work collectively and individually to protect London's position and to develop the market further in line with its market participants' business development strategy regarding licences;

- **Capital efficiency and the chain of security** – A particular strength of Lloyd's is its capital structure and security which provide financial security to policyholders and capital efficiency for members. Lloyd's central assets, including the central fund, currently stand at £2.3bn (which is a record position of strength). There are no plans to change the Lloyd's capital structure but Lloyd's is aware of the need to address several challenges which arise from the introduction of Solvency II;
- **Mutuality and market cohesion** – Lloyd's central fund continues to provide a layer of mutuality which underpins Lloyd's capital strength and reputation for payment. The cohesion of the market also continues to be supported by the work of the principal market associations (the LMA and the LIIBA);
- **Subscription market** - Two-thirds of the Lloyd's market continues to be written on a subscription basis and it remains a key characteristic of the market. Lloyd's believes that the market derives significant strength from being a subscription market but recognises that the processes that support such a system are inherently more complex. Lloyd's aims to continue to pursue market efficiency initiatives in order to make the market an easier place to do business;
- **Diversity in market composition** – Lloyd's believes that diversity is an important characteristic of the market which is desirable from both a risk management perspective and in underpinning the Lloyd's offer to its clients and stakeholders. Lloyd's continues to promote good quality new entrants to the market whilst retaining robust standards for the assessment of new entrant applications. Lloyd's notes that given the current market conditions, potential new entrants may find it harder to prove that they have a realistic, profitable plan;
- **Underwriting expertise and innovation** – One of Lloyd's key strengths is the underwriting expertise in the market which is one of the largest in the world and the level of product development for new and complex risks; and
- **Ratings** – The strategy document highlights Lloyd's existing ratings (A+ with Standard & Poor's and Fitch Ratings, and A with A.M. Best) which remain at Lloyd's target level. As such, no specific actions have been identified.

4. **Areas of focus** – The strategy document identifies that *"there are some areas where additional focus and investment are required over the plan period"*. It highlights market portfolio diversification, the distribution model, market modernisation and market talent as key areas of focus and sets out several responses which Lloyd's intends to undertake during the plan period in relation to these points.

To view the full text of Lloyd's strategy, please click here.

Ian Slingsby

US - Potential revival of the New York Insurance Exchange

As mentioned in the article above, there have been discussions regarding the potential revival of the New York Insurance Exchange (the **"Exchange"**). The original Exchange was established in the 1980s and was intended to stem the flow of business to Lloyd's and offshore insurance and reinsurance markets. The failure of the original Exchange after seven years of operations is generally attributed to soft market conditions and inadequate capital requirements.

In July 2008, the New York State Insurance Department (the **"Department"**) announced that it was considering reviving the Exchange, and, in January 2010, New York Governor David Paterson endorsed the initiative in his annual "State of the State" address when he said: *"By bringing together buyers and sellers of complex commercial insurance, the Exchange will reaffirm our status as the hub of international trade and finance, and it will also curtail the unregulated transactions that devastated the global economy."* As the enabling statutes that established the original Exchange are still on the books, revival of the Exchange will only require action by the Department, not new legislation. Accordingly, since January 2010, the Department has been working with industry representatives to prepare a detailed business plan for a revived Exchange.

Existing legislation provides for the Exchange to be a self-regulatory organization similar to Lloyd's that would operate as a centralized marketplace for brokers and underwriting syndicates. As is the case with Lloyd's, the types of risks to be written on the Exchange would include large commercial risks, such as risks placed through the excess and surplus lines market and reinsurance risks. New York's Superintendent of Insurance, James Wrynn, has suggested that a revived Exchange *"is expected to serve as a market for complicated, unusual or very large risks, backed by investors willing to take on that risk, including traditional insurance companies, hedge funds, private equity funds, investment banks, and wealthy individuals."*

Key challenges that will need to be addressed for a revived Exchange to become a reality include establishing syndicate capital requirements and a mechanism for the Exchange to monitor syndicate capital adequacy (shortcomings in this area are considered to have been a fatal weakness of the original Exchange), gaining support from insurance industry participants, obtaining acceptance from the rating agencies, designing a technologically efficient operating platform, raising $25 million in start-up costs and maintaining the support of the New York Governor's office as Governor-elect Andrew Cuomo takes over from David Paterson on 1 January 2011. If those challenges can be met, 2011 may be the year that a revived New York Insurance Exchange makes its reappearance in the global insurance and reinsurance marketplace.

Lawrence Hamilton

US - New York's Changes to Credit for Reinsurance Regulations

The New York Insurance Department has adopted changes to its credit for reinsurance regulations, which will be effective 1 January 2011. The amendments (i) provide that New York's credit for reinsurance regulations will no longer apply to a non-New York ceding company if its domiciliary state is *"an NAIC-accredited state, or has financial solvency requirements substantially similar to the requirements necessary for NAIC accreditation, and recognizes credit for reinsurance for the insurer's ceded risk"*; (ii) set forth certain prudent reinsurance credit risk management factors including diversification requirements; (iii) include provisions permitting the reduction of the trusteed surplus posted by alien assuming reinsurers under certain conditions; and (iv) most importantly, allow for reduced collateral requirements for credit for reinsurance obtained from unauthorized reinsurers. The amended regulations provide for 0%, 10%, 20%, 75% or 100% collateral requirements from unauthorized reinsurers using ratings-based criteria.

The regulations set forth various factors that the Superintendent of Insurance may consider in determining the ratings for an unauthorized reinsurer (and therefore such reinsurer's collateral requirements), including, among other things, the reinsurer's ratings from the major ratings agencies, compliance with reinsurance contractual terms and obligations, business practices in dealing with ceding companies, reputation for prompt payment of reinsurance claims, and capital adequacy including maintaining more than $250 million of policyholders' surplus.

As discussed in our August 2010 bulletin, Florida similarly revised its credit for reinsurance laws and regulations in 2008 to allow its P&C insurers to receive credit for reinsurance from an unauthorized reinsurer posting less than 100% collateral if the reinsurer meets certain criteria. Other states are expected to follow with similar changes. Unlike New York, where the reinsurance collateral requirements have been changed through revisions to insurance regulations, most states will require legislative action to revise credit for reinsurance sections of their insurance codes and the related regulations.

New York's amendments to its credit for reinsurance regulations are similar to the Reinsurance Regulatory Modernization Framework Proposal Memorandum (the **"NAIC Reinsurance Proposal"**) that was adopted by the U.S. National Association of Insurance Commissioners (**"NAIC"**) in 2008. Under the NAIC Reinsurance Proposal, unauthorized reinsurers may also qualify for reduced collateral requirements under ratings-based criteria. The NAIC Reinsurance Task Force is developing revisions to the NAIC Credit for Reinsurance Model Law and Credit for Reinsurance Model Regulation based on the NAIC Reinsurance Proposal.

In addition, on 16 December 2010, the NAIC adopted the Reinsurance Collateral Reduction & Accreditation Recommendations (the **"NAIC Reinsurance Collateral Recommendations"**), which set forth key elements to be included in the new reinsurance collateral reduction framework for states choosing to reduce collateral for unauthorized reinsurers. The NAIC Reinsurance Collateral Recommendations set forth certain minimum standards and factors that the NAIC expects states to follow when revising their laws and regulations to allow for reduced reinsurance collateral.

The full text of the New York regulatory amendments is available at http://www.ins.state.ny.us/r_finala/2010/rf17&20t.pdf, and the NAIC Reinsurance Collateral Recommendations are available at http://www.naic.org/documents/committees_e_reinsurance_101018_rtf_mod_adopted.pdf.

Vikram Sidhu

Europe - Fifth Quantitive Impact Study update

On 16 December 2010, the Committee of European Insurance and Occupational Pensions Supervisors (**"CEIOPS"**) announced that it has completed the first phase of the fifth Quantitive Impact Study (**"QIS"**). The QIS is *"an exercise, run to assess the practicability, implications and possible impact of specified approaches to insurers' capital setting under Solvency II"*.

CEIOPS noted that the fifth QIS had received far higher participation from European insurance companies (almost 70% for the fifth QIS compared to 33% for the fourth QIS). Commenting on the participation levels Carlos Montalvo (the General Secretary of CEIOPS) said: *"Broad participation of the industry is a key factor to ensure that current options tested under QIS5 are properly taken forward. The results from QIS5 will provide valuable input to help refine the calibration of the Solvency Capital Requirement standard formula as well as the requirements for technical provisions and own funds in the level 2 implementing measures."*

The final report taking into account this feedback from European insurers is expected to be published in March 2011.

To view the full text of CEIOPS press announcement, please click here.

Ian Slingsby

US – NAIC Solvency Modernization Initiative Update

The National Association of Insurance Commissioners (**"NAIC"**) continues to pursue its Solvency Modernization Initiative and held a useful web conference on 7 December 2010. The agenda included the topics of the Own Risk Solvency Assessment (**"ORSA"**), Risk Based Capital (**"RBC"**) and Group Supervision. Presenters included Christina Urias, the Director of the Arizona Department of Insurance and Chair of the Solvency Modernization Initiative Task Force; Alan Seeley, the Chief Property /Casualty Actuary of the New Mexico Insurance Department and Chair of the Solvency Modernization Initiative Risk-Based Capital Subgroup; and Doug Slape, Chief Analyst, Texas Department of Insurance and Co-Chair of the Group Solvency Issues Working Group.

Christina Urias opened the conference with an overview of the Solvency Modernization Initiative (**"SMI"**), the NAIC's critical self-examination of the solvency framework in the U.S. coupled with an analysis of the changing international solvency regulatory landscape. The Director then turned to the future of the U.S. solvency framework. A highlight of her presentation was her discussion of the ORSA. Ms. Urias described November meetings between members of certain NAIC Task Forces and their EU

counterparts where the ORSA was discussed. Following these meetings, the NAIC and the Committee of European Insurance and Occupational Pensions (CEIOPS) agreed to share public documents on ORSA, as well as group supervision issues, and database collection issues. The ORSA mechanism is intended to aid regulators in seeing risk tolerance levels. The Director indicated that the NAIC recognizes that confidentiality will be of critical concern, and the scope and frequency of a U.S. ORSA are still under discussion. When answering a question from an attendee about the nature of the ORSA, the Director stated that between the choices provided by the attendee of the ORSA being a quantitative examination or a discussion of solvency risks by management, she believed that the ORSA would be more like a discussion of solvency risks by management in a narrative format with a statement of a company's risk assessment going forward.

Alan Seeley next gave a presentation on modernization of RBC. The NAIC SMI is examining whether changes should be made to the existing U.S. RBC system. Mr. Seeley indicated that separate RBC versions for life, p/c, and health will still remain, and RBC will still have application to individual insurers, not groups. He noted that internal models are not expected to supplant RBC (at least for the time being). Likely changes in a modernized RBC would include addressing potential gaps or "missing" risks (e.g., catastrophe, operational, "off balance sheet"), improved diversification "credits" and calibrating RBC to a statistical level of safety. Built-in to the determination of target safety levels is keeping overall regulatory capital amounts roughly equal to the current levels and having safety levels comparable to the target levels in other countries. The presentation also included a deliberation on RBC Intervention Levels and whether fewer levels would be sufficient, rather than the current four NAIC levels. The speaker asserted that at least two levels would be necessary to keep; the Action Level - a first, lightest touch with the goal of maintaining an insurer as a going concern; and the Control Level – which is focused on winding up with the least amount of harm. The target preliminary date for completion of NAIC RBC modernization is 2012.

Doug Slape closed the conference with a presentation on the recent action taken by the Group Solvency Issues Working Group ("**GSIWG**") of the SMI Task Force. His remarks included a discussion of the revisions to the Insurance Holding Company System Model Act (#440) and Regulation (#450), which have been adopted by the GSIWG and its Parent E Committee and, at the time of the conference call, were pending approval by the NAIC Joint Executive Committee/Plenary but have since been approved on 16 December. Among a number of revisions were new requirements for an enterprise risk report that identifies material risks within a holding system that could pose enterprise risk to the insurer or the entire holding company system; enhancement to U.S. regulators' ability to participate in supervisory colleges and advice on how to conduct these colleges; enhanced language that allows for compelling production of information for examinations to better ascertain an insurer's health; and enhanced requirements regarding notification of divestiture of controlling interests. The GSIWG is currently evaluating the comments it received on the Holding Company & Supervisory College Best Practices draft document. The GSIWG reviewed options for assessing group capital before and during the Fall NAIC meeting. The GSIWG decided on group capital assessment through an ORSA option with a draft outline of the ORSA to be produced in 2011.

David Alberts

US - Actions taken by NAIC Executive Committee/Plenary

On a conference call of the National Association of Insurance Commissioners (**"NAIC"**) Joint Executive Committee/Plenary on 16 December 2010, the NAIC took the following actions, among others:

- Approved an amended Insurance Holding Company System Model Act and an amended Insurance Holding Company System Model Regulation (including revised reporting forms). In general, the amendments are intended to facilitate the scrutiny by insurance regulators of the financial condition and activities of affiliates of insurers that they believe could pose financial or reputational risk to the insurers. http://www.naic.org/documents/committees_model_440.pdf and http://www.naic.org/documents/index_committees_insurance_holding_co_450.pdf, with last minute changes at http://www.naic.org/documents/committees_model_440_proposed_amendments.pdf
- Approved a Nonadmitted Insurance Multi-State Agreement (**"NIMA"**) to establish a central clearinghouse for receiving and allocating premium taxes on nonadmitted insurance, as authorized by the Nonadmitted and Reinsurance Reform Act of 2010 (which was enacted as part of Dodd-Frank). http://www.naic.org/documents/committees_exec_plenary_101216_nima.pdf
- Adopted recommendations from the Reinsurance (E) Task Force on key elements to be included in the new reinsurance collateral reduction framework for states choosing to reduce collateral for nonadmitted reinsurers. http://www.naic.org/documents/committees_exec_plenary_101216_reinsurance_collateral_reduction.pdf
- Appointed an Executive Committee Task Force on Professional Health Insurance Advisors to *"work in a expedient manner to identify, analyze and recommend options to the Executive Committee for addressing the negative impacts on health insurance brokers/agents, insurance consumers and insurance markets as a result of the Medical Loss Ratio (**"MLR"**) requirements of the Patient Protection and Affordable Care Act (**"PPACA"**) and the regulation as issued by the U.S. Department of Health and Human Services (**"HHS"**)."* The underlying concern here is that the MLR requirements will put the squeeze on agents' commissions.

Lawrence Hamilton

US - Iowa Limited Purpose Subsidiary Life Insurance Companies

The State of Iowa has adopted a new law and related regulations allowing for the establishment of Iowa limited purpose subsidiary life insurance companies (**“LPS”**) that are wholly owned by life insurers domiciled in Iowa. An LPS, which will effectively function like a captive reinsurer, will be allowed to reinsure risks of the parent life insurance company, reinsure risks of other affiliated companies, issue debt securities and otherwise access financial markets and alternative sources of capital through securitizations and other such transactions.

Under the new § 508.33A of the Iowa Insurance Code and the new chapter 99 (Limited Purpose Subsidiary Life Insurance Companies) of the Iowa Administrative Code, which becomes effective on 22 December 2010, an LPS will be authorized only to reinsure the risks of an affiliated ceding insurer (and will be permitted to retrocede the risks subject to regulatory approval), but it will not otherwise be authorized to engage in the business of insurance. The LPS's organizational documents will need to provide that it will always be wholly owned by the organizing life insurer. The LPS will have to maintain unimpaired paid-in capital and surplus of not less than $2.5 million in the form of cash or other securities that are investment grade at the time of acquisition and acceptable to the Iowa insurance commissioner.

The admitted assets of an LPS can include proceeds from a securitization, premium and other amounts payable by a ceding insurer to the LPS, letters of credit, parental guaranties, and any other assets approved by the Iowa insurance commissioner. The ability to count letters of credit and even parental guaranties as admitted assets is a major regulatory development and is expected to provide significant capital relief for Iowa-domiciled life insurers that write substantial amounts of level premium term insurance and/or universal life insurance with no-lapse guarantees (referred to in industry parlance as “XXX” and “AXXX” business, respectively).

Finally, the new regulations clarify that a debt security issued by an LPS will not be subject to regulation as an insurance or reinsurance contract and that an investor or holder of such a security will not be considered to be engaging in insurance business in Iowa solely based on such investment. Nor will the underwriter's placement or selling agents and their employees, representatives, agents and other related parties involved in an LPS insurance securitization be considered to be insurance producers or brokers solely due to the underwriting activities in connection with such securitization. This will eliminate an important source of uncertainty associated with the offering of insurance linked securities in the past.

Lawrence Hamilton* and *Vikram Sidhu

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