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Insurance Industry Group: Global Corporate Insurance & Regulatory Bulletin

US – Federal Regulators propose excluding certain insurance products from swaps regulations

On April 27, 2011, the Commodity Futures Trading Commission (**"CFTC"**) and the Securities and Exchange Commission (**"SEC"**) jointly issued proposed rules and proposed interpretive guidance further defining key terms with respect to the regulation of derivatives under Title VII of the Dodd-Frank Wall Street Reform and Consumer Protection Act. The proposed definitions of the terms "swap" (to be regulated by the CFTC) and "security-based swaps" (to be regulated by the SEC) would exclude, among other things, certain insurance products. Under the proposed rules and interpretive guidance, insurance products would not be considered to be swaps or security-based swaps. To qualify as "insurance" under the proposed rules and interpretive guidance, both the product and the entity providing the product will need to meet certain criteria. Those criteria include the following:

- the beneficiary must have an insurable interest (thereby bearing the risk of loss) continuously throughout the duration of the contract;
- a loss must occur and be proved, and any payment for loss must be limited to the value of the insurable interest;
- the contract must not be traded, separately from the insured interest, on an organized market or over the counter; and
- with respect to financial guaranty insurance only, in the event of payment default or insolvency of the obligor, any acceleration of payments under the policy must be at the sole discretion of the insurer.

In addition, the entity providing the product must be one of the following:

- an insurance company whose primary business activity is writing insurance or reinsurance subject to supervision by a state or federal insurance commissioner;
- the United States or any of its agencies or instrumentalities; or
- only in the case of reinsurance, an entity located outside of the United States providing reinsurance to an insurance company eligible under the proposed rules.

Under the interpretive guidance, certain types of products that do not meet the proposed criteria, if offered by a regulated insurance company, could still be considered insurance, rather than swaps or security-based swaps. Such products include surety bonds, life insurance, health insurance, long-term care insurance, title insurance, property and casualty insurance, and certain annuity products.

The proposed rules are now subject to a period of public comment. Comments are due on or before the date that is sixty (60) days after the date of publication of the proposed rules in the Federal Register. After the comment period has closed, the CFTC and the SEC will consider whether to adopt the proposed rules and interpretive guidance, and in what form.

US – Reinsurance Collateral Reform: Four States Changed, Three States Pending

The pace of reform for US reinsurance collateral and related regulatory requirements is quickening. We have prepared the following "tracking chart" regarding reinsurance collateral developments in the states to-date, including links to the relevant approved or pending statutes and/or regulations, summary of requirements for reinsurers to qualify for posting less than 100% collateral, effective dates for the changes and other relevant information. The chart can be accessed here.

Florida, Indiana, New Jersey and New York have already changed their credit for reinsurance statutes and/or regulations to allow unauthorized reinsurers to qualify for posting less than 100% collateral depending on their financial strength ratings as well as other factors. At this time, Illinois, Louisiana and Texas are also considering bills to make such changes to their credit for reinsurance requirements. Other states are expected to follow.

The pace of change is accelerating due to the federal facilitation arising from Title V preemption under the Dodd-Frank Act and the responsive National Association of Insurance Commissioners (**"NAIC"**) and individual state actions. The NAIC has acted to set some parameters for the changes. In December of last year, the NAIC adopted the Reinsurance Collateral Reduction & Accreditation Recommendations, which 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 from unauthorized reinsurers. The NAIC is also considering revisions to its credit for reinsurance model law and regulation to allow for ratings-based reinsurance collateral reductions, which changes are similar to what the above-mentioned states have already adopted or are considering.

Our team is analyzing these regulatory changes to identify opportunities and issues for market players. For example, some of the topics we are examining with clients include new deal structures and company business models, the impact on reinsurance with affiliates, the scope of preemption and its applicability to trust and LOC requirements, and the reinsurance contract wording implications. As other states adopt changes, we will update our chart in future monthly bulletins.

US – NAIC considers proposal to treat working capital finance notes as invested assets

On March 27, 2011, at the Spring National Meeting of the National Association of Insurance Commissioners (**"NAIC"**), the Valuation of Securities (E) Task Force (**"VOS Task Force"**) evaluated a proposal to allow insurance companies to treat Working Capital Finance Notes as invested assets. The proposal was a joint effort of the NAIC's Securities Valuation Office (**"SVO"**), Pacific Life, and the Nebraska Department of Insurance. The VOS Task Force has exposed the report for a 45-day comment period, which will end on May 13, 2011.

Working Capital Finance Notes are an attractive investment opportunity for insurance companies because they offer higher yields than traditional short-term instruments such as commercial paper, yet retain the low risk of a high-quality short-term instrument. Working Capital Finance Notes are created when a seller of goods delivers goods to a buyer, the buyer accepts the goods, and an invoice is issued that creates a binding obligation on the buyer to make payment. The buyer must confirm that the invoice is for the correct amount, and also that the buyer has no defenses to payment of the invoice amount. The invoice, also referred to as a payable, is then offered to an agent at a discounted rate, often bundled with other similar payables. The agent can then offer the payable to an investor, and the investor can either accept or reject the offer to buy the payable. The original issuer of the invoice, the seller of goods, receives cash for the sale of the payable. The invoice payable is held until it becomes due, and the investor will be credited with the entire amount due on the invoice from the original buyer of goods when payment is made.

Working Capital Finance Note Programs, which have until now been developed by banks but not yet by insurance companies, allow buyers and sellers to use and sell Working Capital Finance Notes on a regular rolling basis. Working Capital Finance Note Programs issue short-term obligations with maturities ranging from 30 to 360 days but usually between 60 to 180 days. The obligations are issued at a discount, mature at par, and are *pari-passu* with other senior unsecured obligations. Through a Working Capital Finance Note Program, a buyer of goods has access to short-term financing for its purchases, the seller of goods receives the proceeds from a sale faster than waiting for the invoice to be paid allowing for greater liquidity and lower cost of funds, and the investor in the Working Capital Finance Note Program gets a higher return than an investment in traditional commercial paper while still maintaining a similar risk profile as if investing in other short-term instruments. In this fashion, the investor can receive a continuous stream of payments from one particular high-credit source.

The SVO proposal is to amend the *Purposes and Procedures Manual of the NAIC Securities Valuation Office* to include Working Capital Finance Notes as invested assets eligible for purchase by insurers. Previously, the Nebraska Department of Insurance had asked the SVO to evaluate the risks of Working Capital Finance Notes and to make recommendations as to whether they qualify as invested assets after Pacific Life had sought clarification under the insurance investment laws in Nebraska. The SVO developed a process for modifying the existing NAIC procedures used to assess risks in bonds so it could be used to evaluate the credit risk of a Working Capital Finance Note Program and enable the SVP to assign a designation. The SVO would employ a two step process consisting of (1) an identification of the obligor's Acceptable Ratings Organizations (**"ARO"**) credit rating and NAIC designation of the obligor, the bank, agent, and any other key parties, and (2) an assessment of the transaction's structure, agreements, and any special attributes. An obligor must have an ARO rating designated NAIC 2 or better in order to be eligible to be part of the Working Capital Finance Note Program.

Letters supporting the treatment of Working Capital Finance Notes as invested assets were submitted to the VOS Task Force by the UNIFI Companies (Ameritas Life Insurance Corp., First Ameritas Life Insurance Corp., Acacia Life Insurance Company, and The Union Central Life Insurance Company) and Mutual of Omaha. The VOS Task Force voted to receive the report from the SVO and expose the report for a 45-day comment period. If the amendments to the *Purposes and Procedures Manual of the NAIC Securities Valuation Office* are accepted, the NAIC will then need to create a regulatory framework to include investment in Working Capital Finance Notes as invested assets.

US – A Reinsurance Sidecar Checklist

Reinsurance sidecars are limited-life, special-purpose reinsurers that, during favorable pricing and underwriting conditions, provide investors exposure to reinsurance risk while allowing sponsor insurers and reinsurers an additional source of capacity and the opportunity to leverage their infrastructure by earning profit commissions. Sidecars emerged as an alternative to newco reinsurers during the hard market after Hurricane Katrina in 2005. Many industry observers are predicting that the series of tragic natural disasters over the past several months may trigger a renaissance of sidecars.

We have prepared a checklist, which is available here, as a tool to assist in developing sidecars and similar vehicles. This checklist is not intended to be comprehensive; it is merely a tool to help identify some of the key issues that arise in developing a sidecar structure.

US – California issues bulletin for guidance on implementation of reinsurance provisions of Dodd-Frank Act

On April 11, 2011, the State of California Department of Insurance (the **"Department"**) released Bulletin No. 2011-2 (the **"Bulletin"**), *Implementation of Reinsurance Provisions of the Federal Nonadmitted and Reinsurance Reform Act*. The purpose of the Bulletin is to inform admitted insurers and other interested parties of the opening response by the Department to the enactment of provisions of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (the **"Dodd-Frank Act"**) regarding reinsurance transactions and additionally to provide clarity to legal matters relevant to the insurance market in California.

Subtitle B of Title V of the Dodd-Frank Act is known as the Nonadmitted and Reinsurance Reform Act of 2010 (the **"NRRA"**). Under the NRRA, if a ceding insurer's state of domicile recognizes credit for reinsurance for the insurer's ceded risk, and that state is either accredited by the National Association of Insurance Commissioners (**"NAIC"**) or has financial solvency requirements substantially similar to the requirements necessary for NAIC accreditation, then no other state may deny the ceding insurer credit for such reinsurance. At present, all fifty states are NAIC-accredited. The NRRA also provides that no other state other than the "home state" of an insured may impose a premium tax on nonadmitted insurance. These two facets of the NRRA are scheduled to become effective on July 21, 2011. With the July effective date rapidly approaching, states have been facing pressure to revise their insurance laws and regulations to conform with the NRRA. Accordingly, the Bulletin, which is effective July 1, 2011, reflects the results of the Department's review of the California Insurance Code (the **"CIC"**) and the reinsurance oversight regulations in Title 10 § 2303 of the California Code of Regulations (the **"CCR"**) and explains how the Department plans on exercising its regulatory powers in response to the credit for reinsurance provisions of the NRRA. Reinsurance transactions executed prior to the effective date of the Bulletin will still require compliance with all rules and regulations under the CIC and the CCR. Existing California law will also apply to statutory statement credit for ceded reinsurance taken on a financial statement with an "as of" date on or before June 30, 2011.

The Bulletin states that the Department will not deny financial statement credit for reinsurance that has been recognized by the domiciliary state of a ceding insurer. With the preemption of certain aspects of state insurance regulation by the NRRA , a number of California statutes and regulations will now only apply to domestic insurers, and are summarized below:

Regulatory Authority	Description	Position of the Department
§ 1011(c) – Reinsurance transaction approval statute	The Department may obtain an order of conservation and take control of the assets of any insurer that, without the Commissioner's prior consent, transfers or attempts to transfer, or enters into a transaction to merge, consolidate or reinsure substantially its entire property or business in or with the property or business of another person	The Department has decided that it will not seek an order of conservation against a non-domestic insurer that does not obtain prior permission for any such reinsurance transactions and will not apply related regulations (§ 2303.15 of the CCR) to non-domestic insurers Non-domestic insurers must, however, still receive prior consent for mergers, consolidations and sale transactions under § 1011(c) of the CIC Domestic insurers must still comply with all aspects of both 1011(c) and § 2303.15 of the CCR.
§ 2303.15(c) through (f) of the CCR	Provides that CIC § 1011(c) is triggered when a sale, cession, assumption or purchase exceeds 75% or more of direct premium written	The Department will not apply Subdivisions (c) through (f) of § 2303.15 of the CCR to a non-domestic insurer 75% or more of an insurer's total premiums or liabilities is the threshold for prior approval of a reinsurance contract only for a domestic insurer
§ 2303.15(f)	Conditions where the Commissioner will consent to a cession of 100% of direct written premium on prospective business to an inter-company pool: • the agreement must provide for a retrocession to the ceding insurer of an amount not less than 10% of its direct written premium • the ceding insurer must maintain surplus at a level sufficient to cover its direct writings	The Department will apply this provision only to domestic insurers Commissioner will not deny consent for a cession to an admitted affiliate solely on the basis that the agreement does not include a retrocession to the ceding insurer 100% cessions to admitted affiliates will generally be acceptable

Regulatory Authority	Description	Position of the Department
§ 2303.15(g) – examination and filing	Generally requires prior review by the Commissioner for reinsurance transactions when the amount of the transaction exceeds 50% or more of the total premium or the total liabilities	The Department will no longer require filings for examination under Subdivision (g) for any insurer whether they are domestic or non-domestic
§ 2303.15(j) - transaction approval regulation	Conditions for consent, approval, or non-objection by the Commissioner for transmission of payments through a reinsurance intermediary for transactions under Subdivisions (e) and (g) of § 2303.15	Since Subdivision (e) will no longer apply to non-domestic insurers and the Department will no longer require filing for examination under Subdivision (g) for any insurer whether they are domestic or non-domestic, Subdivision (j) will apply to domestic insurers only
§ 1215.5(b)(3) of the CIC – for Commercially Domiciled Insurers	Reinsurance agreements for an amount beyond a certain threshold or modifications of such agreements among affiliated insurers may be entered into only if the insurer has notified the Commissioner and the Commissioner has not disapproved the transaction	Commercially domiciled insurers will no longer have to comply with the notification requirements of § 1215.5(b)(3)

Certain other statutes and regulations are catalogued in the Bulletin, and since the Department has made the decision not to disallow credit for reinsurance claimed by a non-domestic insurer for reinsurance that has been recognized by a ceding insurer's domestic state regulator, will be interpreted accordingly. As a final note, the Bulletin states that there are portions of the California reinsurance oversight regulations in § 2303 of the CCR which are not expressly applicable to financial statement credit or and reinsurance agreements, and provisions that are not modified by the Bulletin remain in effect for all licensees. The Bulletin does not restrict the Department's statutory discretion to consider specific circumstances that may arise, and legislation to conform existing California law with the NRRA may be produced in the future.

UK – FSA Solvency II conference speeches

Following the FSA's Solvency II Directive conference on 18 April 2011, two speeches have been published.

HECTOR SANTS, FSA CHIEF EXECUTIVE

In his speech, Mr. Sants focussed on the benefits to the UK which he believes Solvency II will bring. Mr. Sants confirmed that the FSA was not seeking to "*gold-plate*" Solvency II, and that, where it could exercise discretion, it intended to make "*pragmatic and workable*" policy proposals.

Mr. Sants concluded that he believed much of the FSA's current insurance regime was already aligned with Solvency II, but also identified three key benefits which he believed Solvency II would bring to the UK. These were:

1) a significantly enhanced prudential regime for insurers which will provide greater protection for policyholders;

2) the creation of a harmonised regime across Europe; and

3) the raising of standards in non-EU countries.

Hector Sants' speech is available here.

JULIAN ADAMS, FSA DIRECTOR OF INSURANCE

In his speech, Mr. Adams confirmed that the FSA was working towards full implementation of Solvency II on 1 January 2013, and urged firms to prepare on this basis, whilst noting that the policymaking process at EU level "*remains fluid*".

Mr. Adams commented that Solvency II implementation is "*the largest programme of its type ever undertaken by the FSA*", and drew attention to the following key areas of Solvency II:

1) **Reporting** – The UK-specific aspects of the Solvency II reporting regime are to be covered under the FSA's consultation process, and firms were advised to engage fully with this process.

2) **The own risk and solvency assessment process** (**"ORSA"**) – Firms must ensure that all aspects of their business are compatible with Solvency II requirements, and that they implement processes to ensure they can manage the ORSA successfully.

3) **The internal models approvals process** (**"IMAP"**) – Here, the FSA has decided to focus its resources on those firms which represent a significant market share and have the highest potential impact on the FSA's statutory objectives (namely, major life and non-life firms, Lloyd's market firms, and firms which are subsidiaries of major European groups where the FSA will be obliged to participate in a college of supervisors). The FSA will agree a work plan with these firms over the coming weeks. The pre-application phase is aimed as firms reaching a stage at which they can submit a full, formal application to the FSA for model approval. Mr. Adams indicated that applications of this kind could be submitted to the FSA from 30 March 2012 (so later than planned) and that the FSA expected to remain open to formal applications for a two month period, meaning that any firm planning to submit a formal application after May 2012 is unlikely to receive a decision from the FSA before the date on which Solvency II must be implemented.

Julian Adams' speech is available here.

PRC – PRC Criminalises Bribery of Foreign Officials

On 25 February 2011, the Standing Committee of the National People's Congress of the People's Republic of China adopted the Eighth Amendment to the Criminal Law. This included an amendment to Article 164 of the Criminal Law (**"Amendment"**), criminalising the bribery of officials of foreign governments or international public organisations in order to gain an illegitimate commercial benefit. Whether the Amendment will be as extensive in scope and effect as the anti-corruption measures adopted in the US and, more recently, the UK remains to be seen. Foreign-invested enterprises such as sino-foreign joint ventures and wholly foreign-owned enterprises should, however, be particularly aware of the Amendment and adopt/refine preventive measures to ensure full and complete compliance.

PRC CRIMINAL LAW AND CHANGES TO ARTICLE 164

Article 164 of the Criminal Law criminalises the giving of money or property to employees of a private concern with an intent to gain illegitimate benefits.

The Amendment adds a new offence under Article 164 prohibiting the giving of money or property to a foreign government official or an official of an international public organisation with an intention to seek an improper commercial benefit. An entity that breaches this provision may be fined, and the persons directly in charge of the offending entity or other responsible persons may be subject to imprisonment for up to 10 years and/or a fine. The Amendment will become effective on 1 May 2011.

IMPLICATIONS OF THE AMENDMENT

"Foreign official" is defined in the Amendment very broadly and includes any officer or employee of a foreign government, a public international organisation or any of its departments or agencies, or any person acting in an official capacity, regardless of rank or position.

The Amendment demonstrates the continued determination of the PRC authorities to crackdown on corruption and it is significant both in terms of its substance and the message that it is sending both internally and to the rest of the world. The change in the law represents a significant step taken by the Chinese government to bring its bribery laws in line with the current standards set by, for example, the FCPA in the US and the new Bribery Act in the UK.

Articles 6, 7 and 30 of the Criminal Law provide that all PRC citizens within and outside the PRC and all PRC companies (including foreign-invested enterprises) carrying out business in and outside the PRC are subject to the Criminal Law. Given the extra-territorial application of the Criminal Law, a PRC national or entity who bribes a foreign government official while doing business outside PRC could, in theory, be caught by the Amendment. At a time of increasing outbound investment, PRC companies which have overseas business activities with interaction with foreign officials should evaluate their practices and policies and ensure there is in place adequate procedures to prepare themselves for the new challenges the Amendment introduces.

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