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Global Insurance & Regulatory Bulletin

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Asia

CHINA

China Issues Policies on Further Development of the Insurance Industry

The State Council of the People's Republic of China has issued *Several Opinions on Accelerating the Development of the Modern Insurance Industry* ("**2014 Insurance Opinions**"), effective from August 10, 2014.

Further opening up and modernizing China's insurance industry and market is one of the strategic initiatives set out in the 2014 Insurance Opinions. More specifically:

- Foreign insurance companies are encouraged to bring advanced experience and technology into the China market;
- Mergers and acquisitions and reorganizations of insurance companies in China will be systematically regulated;
- The Chinese government will support domestic insurance companies to be listed on both the domestic and overseas stock markets;
- Domestic insurance companies are encouraged to enter overseas markets through various channels and to export their services; and
- The scope of outbound investment using domestic insurance capital is to be expanded.

Earlier this year, the China Insurance Regulatory Commission issued the Administrative Measures for the Merger and Acquisition of Insurance Companies, effective from June 1, 2014. Please refer to our First Quarter 2014 Global Corporate Insurance and Regulatory Bulletin for details.

UK/Europe

UK

PRA Update on Solvency II Implementation

On August 11, 2014, a consultation paper regarding the transposition of the Solvency II Directive into the Prudential Regulation Authority PRA ("**PRA**") rules was published. The paper sets out changes to the PRA's rules required to implement the Directive as amended by Omnibus Directive II.

The paper, CP 16/14 (http://www.bankofengland.co.uk/pra/Documents/publications/cp/2014/cp1614.pdf), considers:

- Changes to primary legislation and the PRA Handbook to implement Omnibus II;
- Areas not covered previously, such as proposals in relation to surplus funds, and areas where the PRA has further developed its approach;
- Feedback on responses to the previous consultation paper, CP 12/13; and
- An economic cost benefit analysis of the most material rule changes proposed in this consultation paper.

The PRA is seeking responses by November 7, 2014.

An update on implementation was published on August 29, 2014, providing information regarding (i) the relationship between the risk margin and calibration of non-hedgeable risks; and (ii) assessing credit risk for matching adjustment portfolios (http://www.bankofengland.co.uk/pra/Documents/solvency2/solvency2updateaugust2014.pdf).

EUROPE

EU-US Insurance Dialogue Project Publishes Revised "Way Forward" Document

Since 2012, the US Federal Insurance Office ("**FIO**"), the European Commission ("**EC**"), the European Insurance and Occupational Pensions Authority ("**EIOPA**") and EU Member State national regulators have engaged in an insurance dialogue project to increase mutual understanding and enhance co-operation between the EU and the US. There are seven key areas that the Project Steering Committee ("**the Committee**") oversees, and in July 2014, an updated Way Forward document was published by the Committee giving recommendations in these areas—the first such document since December 2012, which takes into account developments since the previous document. This new Way Forward document incorporates the following updated objectives and recommendations:

Professional Secrecy/Confidentiality

- In 2012, the Committee stated the objective of encouraging the expanded use of Memoranda of Understanding ("**MoU**") between US states and EU Member States. Now, the Committee wishes to assess the effectiveness of bilateral MoUs on exchanges of information.

Group Supervision

- By the end of 2014, the Committee now aims to have completed an evaluation of the use of a covered agreement to achieve the group supervision objectives in the Way Forward document.

Solvency and Capital Requirements

- The Committee aims to provide a form for the bilateral exchange of views among experts from agencies within the US and EU with regard to the development of basic capital requirements, a high-loss absorbency requirement and an insurance capital standard.

Reinsurance and Collateral Requirements

- The Committee recommends that the EU, US Treasury and FIO, in consultation with state insurance regulators, take initial steps toward a covered agreement by the end of 2014.

Peer Reviews

- The Committee aims for the EU to implement a system to oversee national authorities with regard to how they supervise insurers.

Independent Third-Party Review and Supervisory On-Site Examinations

- The Committee recommends that the EU consider the need for more consistent professional standards surrounding the credentials of actuaries and for actuarial opinions to be made public.

The Project also held a public event on October 25, 2014 for discussion of the evolution in group supervision.

EUROPE

EIOPA Updates Risk Dashboard–September 2014

On September 19, 2014, the European Insurance and Occupational Pensions Authority ("**EIOPA**") published an updated version of its risk dashboard (EIOPA-FS-14/083) (dated September 17, 2014), which takes the form of a presentation.

This latest version of the risk dashboard, which is updated on a quarterly basis, summarizes that the risk environment facing the insurance sector remains broadly unchanged since the last dashboard was published in June 2014. Among other things, based on indicators for the second quarter of 2014, the dashboard lists the following points of interest:

- Market risk is still a concern.
- Liquidity and funding risks have changed, with catastrophe bond issuance reaching an all-time high.
- Credit risk conditions show initial signs of improvement.
- Interlinkages and imbalances still create uncertainties, with contagion risks from banks and sovereigns and high imbalances remaining in both public and private finances.

Data for the EIOPA risk dashboard was submitted by 32 large insurance groups.

EUROPE

Provisional Version of European Commission's Adopted Solvency II Delegated Regulation

On October 10,2014, the European Commission published a provisional version of the text of a Delegated Regulation it has adopted supplementing the Solvency II Directive (2009/138/EC). It also published provisional versions of the 26 Annexes to the Delegated Regulation on its Solvency II webpage, together with an impact assessment and FAQs.

The rules contained in the Delegated Regulation aim to set out more detailed requirements for individual insurance undertakings and groups, based on the provisions set out in Solvency II. They will make up the core of the single prudential rulebook for insurance and reinsurance undertakings in the EU. The rules are based on 76 empowerments in Solvency II (which are listed in Annex 2 to the impact assessment). Some of the empowerments are, in principle, for the European Insurance and Occupational Pensions Authority ("**EIOPA**") to develop draft regulatory technical standards ("**RTS**"). However, they fall within the scope of Article 301b of Solvency II, which provides a sunrise clause under which RTS shall first be adopted in the form of delegated acts.

The Delegated Regulation covers a wide range of areas, including:

- Valuation of assets and liabilities, including technical provisions (and the so called "long-term guarantee measures").
- Methodology and calibration of the minimum capital requirement and the solvency capital requirement (SCR).
- Systems of governance, in particular, the role of the key functions (actuarial, risk management, compliance and internal audit).
- Reporting and disclosure, both to supervisors and to the public.

- Authorization and operation of insurance special purpose vehicles.
- Insurance groups.
- Criteria for assessing third-country equivalence.

The Delegated Regulation will come into force the day after it is published in the Official Journal of the EU. It is hoped therefore that the Delegated Regulation will be finalized by January 9, 2015, following a no-objection review period for the European Parliament. However, if either party invokes its extension option, the regulations would be finalized by April 9, 2015.

Solvency II has to be transposed by member states into national law by March 31, 2015. On April 1, 2015, a number of early approval processes will start. The Solvency II regime will become fully applicable on January 1, 2016.

EUROPE

EIOPA Chairman Comments on Role of the CRO

On October 10, 2014, the European Insurance and Occupational Pensions Authority ("**EIOPA**") published a speech (dated September 26, 2014) given by Gabriel Bernardino, EIOPA Chairman, on a number of topics, including the role of the chief risk officer ("**CRO**").

Points of interest in Mr. Bernardino's speech include the following:

- CROs have helped to shape the new risk-based regime in insurance. In return, regulators have placed risk management as one of the main building blocks. This opportunity should be used to embed a strong culture in firms' day-to-day operations, ensuring that business units themselves "think and act" from a risk management perspective.
- It is important to emphasize that risk management goes well beyond compliance. It is about making sure that risk considerations, and their capital consequences, are explicitly taken into account in the strategic decisions of the firm. The matching of the firm's funds to its risk profile should help to promote a strong risk culture, and can be an essential tool in the sound running of the business.
- Sound governance and risk management evolve over time. It is now particularly important to include adequate strategies and processes to deal with conduct and consumer risk in the governance system. From product design to claims management, insurers need to put customers at the centre of their business decisions. CROs are instrumental in delivering these results, but progress takes time, commitment, effort and a clear "tone from the top".
- In an optimal world, CROs are at the centre of a firm's organization as the failure to take risk behavior into account when setting business strategies and plans puts the firm itself, and its shareholders, in danger. A strong CRO is a very good signal of strong governance from a supervisory perspective, and it definitely helps in attaining the regulatory objectives of increased financial stability and consumer protection. However, having a strong CRO should be seen as sound business practice, and not a regulatory requirement.
- CROs need to find a balance between being the devil's advocate, offering challenge and alternative views, and at the same time being involved in business development and strategy. It is a dual role, where each CRO needs to be "independent but involved".
- EIOPA expects each CRO to set an appropriate risk framework, capable of dealing with risk concentrations and emerging risks. It expects

CROs to contribute to driving the business and to setting the strategy on a sound and sustainable path. To perform this job, the CRO should have a place in the firm's structure that allows the CRO to play an effective role in strategy setting and decision making. CROs need to raise their status within their firm and be part of the board or report directly to the chief executive officer. EIOPA sees a clear movement in this direction, but there are still some firms where the current reporting lines have to be challenged and should be rethought.

EUROPE

German Insurance Market—Can a Corporation Seek Recourse from Its Management for a Fine Imposed on It?

Criminal and regulatory offences committed by a corporation can lead to massive penalties, in particular in case of cartel law infringements. If the cartelist participated in the cartel due to a wrongful act or omission of its management—whether the management actively participated in the cartel on behalf of the corporation or the management insufficiently supervised the business organization—the question arises: Can the company seek recourse from its management for a fine imposed on it?

In England, the Court of Appeal answered this question in the negative in its 2010 decision in *Safeway Stores Ltd v. Twigger,* based on the principle that claimant are prevented from using the courts to obtain compensation for loss which they have suffered due to their own illegal or immoral act.

In contrast, in Germany this question is still open. To date, only the Local Labor Court of the city of Essen has dealt with this issue in a lawsuit involving a damage claim by Thyssen Krupp against a former managing director for recovery of cartel fines in the amount of EUR 191 million. The court suggested, in a rather short obiter dictum, that the managing director could be held liable in principle, but that the amount should be capped at EUR 1 million in order not to deprive the managing director of his economic means of existence. The court did not consider the questions of whether such recourse could be covered under a D&O insurance policy and whether insurance coverage could influence the amount recoverable from the management without depriving it of the economic means of existence. The court did not have to rule on these issues as it found no infringement of any management duty in the first place. Currently, an appeal is pending with the Regional Labor Court of the City of Düsseldorf. It remains to be seen if the Regional Labor Court will rule on the recoverability of fines at all or whether it will dismiss the appeal on the basis that management obligations have not been violated.

Among German law professionals, it is highly debated whether fines are recoverable from management and, if so, to what extent. Whereas it is largely accepted that under the provisions of German civil and corporate law, such fines can be passed on to management in the first instance, many scholars perceive it as unfair and overly burdensome that managing directors would face unrestricted liability even for slight negligence. For this reason, various legal concepts are proposed which exclude or at least restrict liability for fines. However, it remains to be seen if the courts are prepared to follow this approach. Indeed, it is questionable whether any restriction of liability is consistent with the law as it currently exists. The courts may well find that any restriction of liability would require a change of the law by the legislator.

To the extent that a fine absorbs illegally obtained profits, such amount does not constitute a damage for the company because the company would not

have obtained this profit if no breach of law had occurred. However, if the administrative order imposing the fine does not explicitly state to which extent it absorbs illegal profits—as is the case with cartel fines—the burden of proof for the amount of the illegal profits rests with the managing director. In the absence of discovery and disclosure proceedings under German civil procedural law, this burden is hard to overcome in practice.

As a result, under the prevailing law there is a high risk for managing directors that they can be held liable to the full amount of damages if a fine is imposed on the company. In this case it would be consistent to find that such recourse is covered under the D&O insurance policy to the extent the insured person did not act intentionally. Such insurance coverage would also not be excluded by a possible exclusion of criminal and regulatory fines in the policy (as you can see in some wordings) as, technically, the company does not forward the fine to the managing director but seeks compensation for the loss caused by the fine.

D&O insurers should monitor this development in the German market carefully and consider appropriate wording in their policies. It should be noted that most wordings used in the German market do not explicitly refer to coverage of recourse claims regarding fines.

If you have any questions or require specific advice on any matter discussed in this publication, please contact one of the lawyers listed at the end of this Bulletin.

US/Americas

US

Governance Annual Disclosure Model Act and Regulation

On August 17, 2014, the National Association of Insurance Commissioners' ("**NAIC**") Financial Condition (E) Committee finalized a Corporate Governance Annual Disclosure Model Act and supporting Model Regulation (the "**Corporate Governance Model Law and Regulation**") after nearly five years of discussion. This multi-year project was part of the NAIC's Solvency Modernization Initiative ("**SMI**"), which included the formation of the Corporate Governance (E) Working Group ("**CGWG**") "to study and compare existing governance requirements for US insurers to established best practices, international standards and US regulatory needs."

The Corporate Governance Model Law and Regulation, if adopted by the NAIC Executive Committee and Plenary on November 18, 2014, will provide insurance regulators a means to collect information on the corporate governance practices of US insurers on an annual basis. The information collected will be accorded confidential treatment to the extent that it contains "confidential and sensitive information related to an insurer or insurance group's internal operations and proprietary and trade secret information which, if made public, could potentially cause the insurer or insurance group competitive harm or disadvantage." Under the requirements of the Corporate Governance Model Law and Regulation, domestic insurers will be required to submit a Corporate Governance Annual Disclosure ("CGAD") no later than June 1 of each year.

Some of the key items required to be included in the CGAD include:

- Corporate governance framework and structure including duties and structure of the board of directors and its significant committees, as well as a discussion of the roles of chief executive officer and chairman of the board;
- The policies and practices of the board of directors and its significant committees, including appointment practices, the frequency of meetings held and review procedures;
- The policies and practices for directing senior management, including a description of suitability standards, the insurer's code of business conduct and ethics, processes for performance evaluation, compensation and corrective action, and plans for succession; and
- The processes by which the board of directors, its committees and senior management ensure an appropriate level of oversight to the critical risk areas impacting the insurer's business activities.

The new disclosure requirements are expected to apply beginning in 2016, and the CGWG intends to recommend that state adoption of the Corporate Governance Model Law and Regulation be made an NAIC accreditation standard.

US

The NAIC Process for Developing and Maintaining the NAIC List of Qualified Jurisdictions for Certified Reinsurers

In 2011, the NAIC Credit for Reinsurance Model Law and Regulation were amended to reduce the collateral requirements for certain unauthorized reinsurers. Prior to the amendments, reinsurers that were not authorized or accredited in the cedant's domiciliary jurisdiction were generally required to post 100% collateral for the liability being assumed. The amendments allow unauthorized reinsurers "certified" by the cedant's domiciliary jurisdiction to post collateral based on financial strength and business practices of the reinsurer and determined on a sliding scale. Only reinsurers licensed and domiciled in a "qualified jurisdiction" are eligible to become certified. In 2012, a Qualified Jurisdiction (E) Working Group ("QJWG"), established by the NAIC's Reinsurance (E) Task Force ("RTF"), developed criteria and processes for identifying non-US jurisdictions that are qualified jurisdictions and created a procedures manual, the "Process for Developing and Maintaining the NAIC List of Qualified Jurisdictions" (the "Qualified Jurisdiction Process"). The QJWG has since performed expedited reviews on four jurisdictions (Bermuda, Germany, Switzerland and the United Kingdom), each of which has been placed on the NAIC list of qualified jurisdictions as a "conditional qualified jurisdiction" pending full review. Three additional jurisdictions (France, Ireland and Japan) have agreed to participate in the process and are currently under review by the QJWG.

The Qualified Jurisdiction Process requires a qualified jurisdiction to agree to share information and cooperate on a confidential basis with the US state insurance regulatory authority with respect to all certified reinsurers domiciled within that jurisdiction. The initial draft of the Qualified Jurisdiction Process directed the NAIC staff to create a template memorandum of understanding ("MOU") to be used with each qualified jurisdiction. However, during the initial expedited reviews conducted in 2013, the QJWG discovered that the jurisdictions under review strongly preferred to use the International Association of Insurance Supervisors ("IAIS") Multilateral Memorandum of Understanding ("MMOU") for cooperation and information sharing between insurance supervisors, rather than entering into individual MOUs with multiple NAIC

jurisdictions. However, because not all certifying states have become signatories to the IAIS MMOU, the QJWG recommended allowing those states not yet party to the IAIS MMOU to enter into an MOU with a "lead state" that is a party to the IAIS MMOU. The lead state may then share information with those states under the provisions of the NAIC Master Information-sharing and Confidentiality Agreement, which essentially provides that (i) each state has the authority to share confidential information with regulatory officials of any state, federal agency or foreign countries and the NAIC; and (ii) each state has the authority to keep confidential information obtained from any state, federal agency or foreign countries and the NAIC that is considered confidential in its jurisdiction.

A revised Qualified Jurisdiction Process reflecting the above recommendation was adopted by the RTF on August 17, 2014.

Reinsurers seeking status as a certified reinsurer are encouraged to submit initial applications to a single state, in an effort to facilitate multistate recognition of certification through a "passporting" process developed by the NAIC Reinsurance-Financial Analysis (E) Working Group (the "Reinsurance FAWG"). That state will generally be considered the "lead state" for purposes of the certification process. Upon receipt of the application, the commissioner of the lead state will submit notice of the application to the Reinsurance FAWG, along with information provided by the applicant. The lead state will also present its evaluation of the application to the Reinsurance FAWG at its next meeting. As part of its review process, the state may also request the assistance of NAIC staff in completing its evaluation. Members of the Reinsurance FAWG will review the lead state's report and will have an opportunity to provide input or submit inquiries with respect to the lead state's final certification of the applicant. After considering input from the Reinsurance FAWG, the lead state commissioner will issue written notice to the applicant upon determination that it has been approved as a certified reinsurer.

The role of the Reinsurance FAWG is intended to facilitate communication and consistency among NAIC member jurisdictions with respect to the certification process. Once a reinsurer has been certified by an NAIC-accredited state using the foregoing process, it is eligible to apply for certification in other states using a Uniform Application Checklist for Certified Reinsurers developed by the Reinsurance FAWG and approved by the RTF on August 17, 2014. Rather than conducting a *de novo* review process, the commissioners in those other states can then rely on the lead state's certification process and defer to the lead state's certification decision, as well as the rating assigned to the reinsurer by the lead state. This is informally referred to as "passporting."

The QJWG has utilized a similar concept of a lead state in its evaluation of qualified jurisdictions. Under this process, a reinsurer domiciled in a jurisdiction that has not been approved as a qualified jurisdiction by the NAIC may apply for certification in a lead state, which may evaluate the jurisdiction in accordance with the Qualified Jurisdiction Process, the results of which are shared with the QJWG for its review and final approval. Alternatively, the lead state may request the NAIC to perform the review, but remain as the primary contact with the reinsurer and the supervisory authority of the reinsurer's domiciliary jurisdiction.

US

NAIC Group Solvency Issues Working Group to Revise the Model Holding Company Act to Add Provisions Regarding "Group-Wide Supervision of Internationally Active Insurance Groups"

At the NAIC Spring National Meeting in March 2014, the Group Solvency Issues (E) Working Group ("**GSIWG**") was tasked with considering whether amendments should be made to address issues that have arisen since the adoption of the 2010 amendments to the Model Insurance Holding Company System Regulatory Act (the "HCA Model Act"). Specifically, the GSIWG was to consider whether the HCA Model Act should be amended to address the following:

1. Provide states with clear legal authority and delineated powers to act as the group-wide supervisor for internationally active insurance groups (IAIGs) and other large insurance groups;
2. Provide direct legal authority over the insurance holding company, including the authority to set group capital requirements;
3. Provide for group-wide financial reporting for large insurance groups; and
4. Consider resolution plans for IAIGs and other large insurance groups.

The GSIWG is currently focusing its efforts on the first task, which it is pursuing by drafting a new Section 7A of the HCA Model Act to address "Group-wide Supervision of International Insurance Groups." The new provision would designate the insurance regulatory official of a single US state to act as the group-wide supervisor of such groups. The proposed changes were exposed for comments in September 2014. The GSIWG subsequently held conference calls on October 3rd and 24th to discuss comments received from the industry.

One of the key concerns from the industry relates to the scope of the group-wide supervisor's authority. The current draft provides that "[t]he commissioner is authorized to act as the group-wide supervisor for any international insurance group…" The term "international insurance group" is defined as an "insurance group operating internationally that includes an insurer…that is part of an insurance holding company system." A number of industry representatives expressed the view that the new Section 7A should only apply to "internationally active insurance groups" ("**IAIGs**"), as defined by the IAIS, so that regulatory attention would be focused on groups "where there is likely to be the most group-wide supervisory activity of consequence." Although the GSIWG initially rejected this suggestion, during the October 24 call, the GSIWG agreed to leave the issue open for follow up discussion.

A second draft of the revised HCA Model Act is expected prior to the NAIC Fall National Meeting, and the GSIWG plans to have another conference call on November 7 to further discuss the changes and to give the industry another opportunity to comment on the draft before the GSIWG's November 16 session at the Fall National Meeting.

US

Update on Captive Reserve Framework Implementation

As reported in our Second Quarter 2014 Global Corporate Insurance & Regulatory Bulletin, the NAIC has made significant progress in addressing reserve financing issues, particularly those relating to the use of captive reinsurers for so-called AXXX and XXX reserve financing transactions. On August 17, 2014, the NAIC Executive Committee formally adopted the XXX/AXXX Reinsurance Framework for financing transactions relating to (1) reserves required for level premium term line insurance policies under Regulation XXX and (2) reserves required for universal life insurance policies with secondary guarantees under Regulation AXXX (the "Framework") and charged the Principle-Based Reserving Implementation (EX) Task Force (the "PBRI Task Force") with overseeing the implementation of the Framework. A detailed summary of the Framework and the implementation steps to be undertaken can be found in our prior Bulletin (referenced above). Since the formal adoption of the Framework by the NAIC, the following implementation steps have been taken:

- At a conference call held on October 9, 2014, the PBRI Task Force exposed for comment an "Updated DRAFT Actuarial Guideline XLVIII: Actuarial Opinion and Memorandum Requirements for the Reinsurance of Policies Required to be Valued under Sections 6 and 7 of the NAIC Valuation of Life Insurance Policies Model Regulation (Model 830)" ("Draft AG 48") dated October 7, 2014. Draft AG 48 is responsive to the PBRI Task Force's charge to the Life Actuarial (A) Task Force to develop an actuarial guideline to provide interim guidance for the Actuarial Opinion Memorandum Regulation, specifying that the opining actuary must issue a qualified opinion as to the ceding insurer's reserves if the ceding insurer or any insurer in its holding company system has engaged in a XXX/AXXX reserve financing transaction that does not adhere to the Actuarial Method and Forms of Primary Security adopted by the NAIC. Draft AG 48 includes options for alternative language on key points, including:
  - Options for the definition of "Primary Security" that vary in whether letters of credit are included in the definition and whether the general inclusion of securities listed by the NAIC Securities Valuation Office in the definition should have a carve-out for synthetic letters of credit, contingent notes, credit-linked notes and similar securities;
  - Options for defining those reinsurance contracts that would be "grandfathered;" and
  - An option for an additional exemption available through joint petition by the ceding insurer and its domestic regulator to the NAIC Financial Analysis Working Group ("FAWG").

Comments on Draft AG 48 were due on October 30, 2014. The PBRI Task Force plans to meet on November 6, 2014 to discuss Draft AG 48 and hopes to formally adopt a final version of Draft AG 48 in November. While the requirements for acceptable Forms of Primary Security and the Actuarial Method are ultimately intended to be codified in amendments to the NAIC Credit for Reinsurance Model Law and a new model regulation thereunder, the final version of Draft AG 48 is intended to be an interim measure to provide uniformity and implementation of the Framework's key principles effective January 1, 2015, pending the lengthy process of finalizing those models and their adoption by the states (Draft AG 48 will sunset with respect to ceding insurers domiciled in a jurisdiction that adopts these models and has them in effect at January 1 of the calendar year preceding the year in which the actuarial opinion is to be filed), and it is

expected that the approach taken in the final version of Draft AG 48 will be reflected in the new model regulation.

- On September 19, 2014 the Blanks (E) Working Group, the Accounting Practices and Procedures (E) Task Force, and the Financial Condition (E) Committee adopted a Supplemental XXX/AXXX Reinsurance Exhibit for insurers to file as par of their statutory annual statements for the year ending December 31, 2014.

- The Financial Analysis Handbook Working Group is considering comments to proposed revisions to the *Financial Analysis Handbook* to address standards for Form D approval of captive reinsurance transactions, review of life insurer reinsurance transactions and group-wide supervision. That Working Group will hold a conference call on November 6, 2014 to discuss those topics.

US

NAIC Private Equity Issues (E) Working Group Continues Drafting of Additions to *Financial Analysis Handbook* for Regulatory Review of Acquisitions of Insurers

In our Second Quarter 2014 Bulletin, we reviewed the efforts of the NAIC Private Equity Issues (E) Working Group (the "PEI Working Group") to draft changes to the NAIC's *Financial Analysis Handbook* to provide additional guidance for state insurance examiners who review "Form A" applications for acquisitions of control of insurers. The PEI Working Group has held two subsequent meetings, an in-person meeting at the NAIC Summer National Meeting on August 7, 2014, and a telephonic meeting on October 23, 2014. At the October 23, 2014 meeting, the PEI Working Group approved a number of revisions to its original exposure draft in response to comments from members of the working group and comments from Athene Holding Ltd. Those revisions can be found here.

A number of the revisions to the draft pertain to the types of stipulations that regulators can impose when they conclude that a proposed acquisition would not otherwise satisfy the statutory criteria for Form A approval, and to the types of post-acquisition procedures that regulators may wish to follow in order to ascertain whether the proposed acquisition and the acquirer's business plan are being executed as anticipated. The following is a list of those possible stipulations and procedures as they appear in the PEI Working Group's revised draft:

STIPULATIONS FOR A LIMITED PERIOD OF TIME

- Requiring RBC to be maintained at a specified amount above company action level, because capital serves as a buffer that insurers use to absorb unexpected losses and financial shocks—better protecting policyholders;

- Requiring quarterly RBC reports rather than annual reports as otherwise required by state law;

- Prohibiting the insurer from paying any ordinary or extraordinary dividends or other distributions to shareholders unless approved by the Commissioner;

- Requiring a capital maintenance agreement from or establishment of a prefunded trust account by the acquiring entity or appropriate holding company within the group;

- Enhancing scrutiny of operations, dividends, investments and reinsurance by requiring material changes in plans of operations to be filed with the Commissioner (including revised projections), which, at a minimum, would include

affiliate/related party investments, dividends or reinsurance transactions to be approved prior to such change; and

- Requiring a plan to be submitted by the group that allows all affiliated agreements and affiliated investments to be reviewed despite being below any materiality thresholds otherwise required by state law.

CONTINUING STIPULATIONS

- Requiring prior Commissioner approval of material arm's-length, nonaffiliated reinsurance treaties or risk-sharing agreements;
- Requiring notification within 30 days of any change in directors, executive officers, managers or persons acting in similar capacities of controlling entities, and biographical affidavits and such other information as shall reasonably be required by the Commissioner;
- Requiring the filing of additional information regarding the corporate structure, controlling persons and other operations of the company;
- Requiring the filing of any offering memoranda, private placement memoranda, any investor disclosure statements or any other investor solicitation materials that were used related to the acquisition of control or the funding of such acquisition;
- Requiring disclosure of equity holders (both economic and voting) in all intermediate holding companies from the insurance company up to the ultimate controlling person or individual, but considering the burden on the acquiring party against the benefit to be received by the disclosure;
- Requiring the filing of audit reports/financial statements of each equity holder of all intermediate holding companies, but considering the burden on the acquiring party against the benefit to be received by the disclosure; and
- Requiring the filing of personal financial statements for each controlling person or entity of the insurance company and the intermediate holding companies up to the ultimate controlling person company. Controlling person could include for example, a person that has a management agreement with an intermediate holding company.

POST-ACQUISITION PROCEDURES

- Examining the insurer and its affiliates to ensure that the investment strategy continues to provides a prudent approach for investing policyholder funds or does not create excessive contagion risk;
- Requiring ongoing annual stress testing of the insurer and the group in accordance with existing laws and regulations. This includes stress testing not only the investments but also the policyholder liabilities to ensure that the assets and liabilities continue to be properly matched;
- Periodically reviewing of the investment management and other affiliated agreements, including reviewing the equity firm fees and fee structure charged or to be charged to the insurer, if any, as well as arrangements with intercompany broker to ensure that they continue to be fair and reasonable and examine the flow of funds related to such agreements;
- Coordinating a meeting with multiple regulators and even all states to the extent there is a need for all regulators to better understand the business plan and operations of the group; and
- Coordinating an examination with another regulator of nonaffiliated insurers where the direct writer has ceded a material portion of their risk to a separately controlled insurer.

The PEI Working Group will consider adopting the draft guidance at its November 17, 2014 session during the NAIC Fall National Meeting. The first half of that session will be devoted to a presentation by

Igor Rozenblit, Co-Chair of the Private Funds Unit at the US Securities and Exchange Commission, so that the working group can take the SEC's perspective into account before finalizing its draft.

US

A Second Effort to Establish a National Association of Registered Agents and Brokers (NARAB II)

A provision in the federal Gramm-Leach-Bliley Act of 1999 ("**GLBA**") provided for the creation of a National Association of Registered Agents and Brokers (NARAB), a nonprofit organization, to administer the licensing of insurance agents and brokers (referred to generically as "insurance producers") on a nationwide basis. However, the GLBA provision allowed the states to prevent the creation of NARAB if a majority of insurance regulatory jurisdictions in the United States enacted legislation providing for uniformity or reciprocity of multi-state producer licensing. That prompted the NAIC to develop a Producer Licensing Model Act ("**PLMA**") to streamline the non-resident licensing process for insurance producers, and a sufficient number of states adopted new licensing statutes based on the PLMA to prevent the creation of NARAB. Even so, despite the adoption of PLMA by most states, the desired uniformity in the producer licensing process remains unfulfilled, as several large states continue to impose different requirements.

The continuing call for uniformity in insurance producer licensing has been gaining momentum in recent years, and the House of Representatives passed the National Association of Registered Agents and Brokers Reform Act of 2013 (often called NARAB II) as a stand-alone bill (H.R. 1155) in September 2013 to move forward with the creation of NARAB, empowering it to implement licensing, continuing education and other nonresident insurance producer qualification requirements on a multi-state basis. In June 2014, the House Financial Services Committee attached the same NARAB II measure to a Terrorism Risk Insurance Act ("**TRIA**") reauthorization bill—the TRIA Reform Act of 2014 (H.R. 4871), which has not yet passed the full House. In July, the Senate also attached NARAB II (in virtually identical form) to its version of the TRIA reauthorization bill (S. 2244), which has passed the full Senate.

NARAB II, which has the support of the NAIC, the FIO, and most of the insurance industry, would "provide a mechanism through which licensing, continuing education, and other nonresident insurance producer qualification requirements and conditions may be adopted and applied on a multi-state basis" for members of NARAB, but would preserve states' rights with respect to the following:

- Licensing, continuing education and other qualification requirements of insurance producers that are not members of NARAB;
- Resident or nonresident insurance producer appointment requirements;
- Supervision and discipline of resident and nonresident insurance producers;
- Establishing licensing fees for resident and nonresident insurance producers so that there is no loss of insurance producers licensing revenue to the state; and
- Prescribing and enforcing laws and regulations regulating the conduct of resident and nonresident insurance producers.

Any insurance producer licensed in its home state would be eligible to become a NARAB member, provided that the producer's state license has not been suspended or revoked and the producer undergoes a criminal background check.

Although the industry would prefer NARAB II to be enacted as a stand-alone measure, NARAB II may have a better chance of becoming law as part of the TRIA reauthorization legislation— similar to the way in which the Nonadmitted and Reinsurance Reform Act, which had previously passed the House of Representatives multiple times, was ultimately enacted into law as part of the Dodd-Frank Wall Street Reform and Consumer Protection Act.

Message from the Editors

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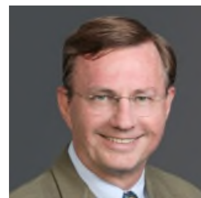

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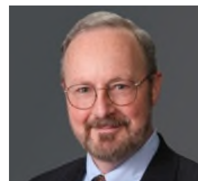

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