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NAIC Tackles Capital Requirements, Redundant Life Reserves and More at Fall National Meeting

At its 2015 Fall National Meeting in National Harbor, Maryland, Nov. 18-21, the National Association of Insurance Commissioners, or NAIC, moved ahead on a number of key issues affecting the insurance and reinsurance industries. Highlights included the following.

Credit for Reinsurance

The Reinsurance Task Force voted to expose for public comment five options for revisions to the Model Credit for Reinsurance Law. The revisions would accommodate the forthcoming model regulation on reinsurance of term life and universal life with secondary guarantees (so-called Reg. XXX-AXXX risks). The forthcoming model regulation, based on Actuarial Guideline 48 adopted in December 2014, will likely relax certain collateral requirements associated with reinsuring these kinds of policies by allowing any type of asset (in the commissioner's discretion) to constitute valid security for such reinsurance above certain levels of reserves. Below that level (the so-called Required Level of Primary Security), collateral must consist of specified high-grade investments.

The five options would amend the Model Law to grant the relevant state's insurance commissioner discretion to impose requirements consistent with the expected Reg. XXX-AXXX credit for reinsurance regulation. The versions differ in some of their details as to scope, with certain options covering more lines of business than others and one option excluding widely licensed or widely accredited reinsurers. These various nuances were discussed at the Task Force meeting. Among other concerns raised by interested parties at the meeting, some participants argued that the Model Law's proposed grant of authority to the state commissioner is excessive, given the intended narrow focus on Reg. XXX-AXXX risks. Others expressed the concern that future parties to reinsurance agreements would not have sufficient certainty *ex ante* on their ability to take balance sheet credit because of the risk that the regulator could subsequently introduce a retroactive approval requirement. The credit for reinsurance issue seems likely to continue well into 2016.

International

The International Insurance Relations (G) Committee, which focuses on the NAIC's coordination with international regulatory regimes and includes the ComFrame Development and Analysis Working Group, or CDAWG, approved CDAWG's recommendation for the NAIC to develop its own group capital calculation standards for U.S. insurance groups. Such standards, regulators stressed, are not intended to serve as separate capital requirements independent of the contemporaneous developments at the International Association of Insurance Supervisors (IAIS), but rather to serve as a tool to help state regulators interact with international bodies and to ensure that the U.S. state-based approach to group supervision is accounted for as international standards are developed.

To this end, the International Committee approved a recommendation previously adopted by CDAWG that requests that the NAIC Executive Committee and Plenary charge the Financial Condition (E) Committee to:

> "Construct a U.S. group capital calculation using an [risk-based capital] aggregation methodology; liaise as necessary with [CDAWG] on international capital developments and consider group capital developments by the Federal Reserve Board, both of which may help inform the construction of a U.S. group capital calculation."

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Although CDAWG has previously considered various approaches to developing such standards (including using approaches based, respectively, on existing statutory accounting standards and GAAP standards), the group recommended an "RBC aggregation" approach that would build on pre-existing legal entity risk-based capital requirements rather than developing new standards. Such an approach, the group concluded, would be less burdensome and costly to regulators and industry alike, would respect other jurisdictions' existing capital regimes, and would be the quickest to develop and implement. The Executive Committee adopted this charge at the Fall National Meeting, and it now awaits final action by the Plenary in a year-end conference call.

RBC and Investment Affiliates

The Property and Casualty Risk-Based Capital (E) Working Group considered the proposal of the Capital Adequacy Task Force, or CATF, to ascribe a capital charge to "investment affiliates" of property-casualty insurers (see our prior client alert on this topic **here**). The NAIC defines an "investment affiliate" as any affiliate of the insurer, other than a holding company, that is engaged or organized primarily to participate in the ownership and management of the insurer's investments. An insurer might use an investment affiliate for administrative purposes or as a "blocker" for legal, tax or other motivations.

Currently, the RBC charge for a property-casualty insurer's investment in an investment affiliate is based on the RBC of the underlying assets, prorated to account for such insurer's degree of ownership of these underlying assets. This "look through" approach assumes that the charge for an investment affiliate should be the same as if the insurer held the assets directly. The insurer's equity interest in the affiliate itself is thus disregarded, and the insurer does not incur a capital charge in respect of such equity interest (ordinarily, insurers must hold more capital against equity investments than debt). CATF has proposed to abandon this "look through" approach and impose an RBC charge for an investment in an investment affiliate to be based on a certain, as yet undetermined, percentage multiplied by the carrying value of the investment affiliate's common and preferred stocks and bonds. The P&C RBC Group agreed to defer further action until the Investment Risk-Based Capital Working Group has the opportunity to further review the proposal.

While the NAIC has not yet proposed a specific percentage associated with such capital charge, any change may have significant implications for how insurers structure merger and acquisition transactions, joint ventures, and other structured investments in their asset portfolios. The benefits of using an investment subsidiary (administrative simplicity, legal remoteness, etc.) would have to be weighed against the incremental capital cost, potentially frustrating such benefits. This change to the RBC regime is already being applied to health insurers.

Receivership and Insolvency

The Receivership and Insolvency Task Force adopted revisions to the "Receivers Handbook for Insurance Company Insolvencies" relating to the materials and data that a receiver should request for pre-receivership planning guidance. The revisions to the handbook augment the authority of a prospective receiver to request additional information, as evidenced by the examples set forth below of what a receiver may now consider. These broadened categories of information that a regulator may obtain reflect some of the major regulatory trends of the post-2008 era--a focus on groups rather than legal entities, concerns regarding valuation and risks resulting from nontraditional investment instruments such as derivatives. Assuming these revisions are advanced by the Task Force's parent bodies, insurers approaching insolvency can expect a more rigorous review by their domiciliary regulators as these officials prepare to petition a court for rehabilitation or liquidation authority.

Receivers may now seek, in the pre-petition stage, the following information:

- An organizational chart of the insurer and its subsidiaries and affiliates that describes, among other items, the holder of each legal entity and foreign office; provides the location, jurisdiction of incorporation, licensing, and key management associated with each material legal entity and foreign office identified; and identifies whether the company utilizes any third-party vendors.
- A description of the corporate governance structure and processes related to resolution planning.
- A detailed inventory and description of the key management information systems and applications, including those for risk management, policy and claims administration, reinsurance, and financial and regulatory accounting used by the company and its material entities.
- The processes the company employs for determining the current market values and marketability of the core lines of business, critical operations, and material asset holdings of the company.
- Information relating to payroll and employee benefits.
- Disclosure regarding the company's involvement in derivatives.

The Receivership Task Force also received an update on federal legislative developments related to insurance insolvency, highlighting the U.S. House of Representatives' passage of the Policyholder Protection Act of 2015 on Nov. 16, 2015. The bipartisan-led legislation, which is widely supported by state regulators and industry, clarifies, among other provisions, state insurance regulators' authority to wall off insurance company assets within savings and loan holding companies in order to protect insurance consumers. The bill also prevents the Federal Deposit Insurance Corporation from placing liens on an insurer's assets without the approval of the applicable state insurance regulator. The legislation is pending in the Senate.

Workers' Comp

The Workers' Compensation Task Force heard a report concerning ongoing updates to the NAIC's 2006 study on large-deductible workers' comp policies. The update process involves regulators, insurers, guaranty funds, professional employment organizations (PEOs), trade associations and state workers' comp administrators. The organizers of the update are focused particularly on solvency concerns and claims challenges arising from the use of large-deductible plans, as well as on the distinctive issues presented by PEOs, which affect underwriting practices and day-to-day administration.

The Task Force discussed the potential for abuse and inefficiency suggested in the update's findings but did not conclusively identify any prospective requirements or enforcement measures, although a related NAIC session did note that recently enacted Illinois Senate Bill 1805 imposes collateral requirements on some large-deductible workers' comp arrangements. Specifically, S.B. 1805 mandates that an insurer having (i) a rating below A-minus from A.M. Best and (ii) less than $200 million in surplus must require its policyholder to post collateral in respect of its obligations where the workers' comp policy provides for a $100,000 or greater per-claim or per-occurrence deductible. The legislation also caps a policyholder's obligations under such a

policy at 20 percent of the policyholder's net worth. PEOs featured prominently in these discussions, with meeting participants noting that a PEO's status in the case of an insolvent client and outstanding workers' comp obligations can be difficult to navigate for beneficiaries and regulators alike. Speakers called for safeguards to make PEOs and employers generally more accountable, particularly in the case of these high-deductible plans. The changing landscape of labor, employment and health care will make workers' comp a key area of focus for the NAIC in the coming months and years.

Our Insurance and Reinsurance Practice

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