New Rules
For the New Year

A roundup of the regulations that will be on insurers' minds in 2014.

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Managing regulatory change continues to be a top concern in the financial sector. The onset of the new year presents an opportunity to survey changes and current trends in regulation that affect insurers.

Here is a broad overview of the regulatory issues we will be following during 2014.

International

Five years ago very few summaries of emerging developments in insurance regulation would have even included an international section. The 2008 financial crisis changed that. In 2009, the Group of 20 created the Financial Stability Board to coordinate the work of national financial authorities at the international level, and insurance has become an integral part of the emerging international regulatory framework. The FSB, working with the International Association of Insurance Supervisors, is driving the identification of globally systemically important insurers and recommending how national regulators should supervise G-SIIs. This is planned to be extended to internationally active insurance groups, regardless of their systemic importance.

Beginning in 2014 the FSB, through the IAIS, is expected to develop backstop capital requirements to apply to all G-SII group activities, including non-insurance activities, and to develop higher loss absorbency requirements that will apply to G-SIIs beginning in 2019. This year will also see the designation of the first reinsurers as G-SIIs (one year after the July 2013 designation of the first nine insurance G-SIIs).

Meanwhile, the IAIS continues its work on the Common Framework for the Supervision of Internationally Active Insurance Groups. The IAIS released a revised version of ComFrame in October and announced it has already begun field testing the latest version with the expectation that jurisdictions will begin implementing ComFrame in 2018.

Of added interest, the revised ComFrame is being developed to include the first-ever Risk-Based Global Insurance Capital Standards intended for implementation in 2019. Although these schedules sound definite, the content of most of these new initiatives is still in development and will no doubt be the key set of issues to monitor in 2014.

This year, the United States will undergo its second Financial Sector Assessment Program conducted by the International Monetary Fund. The 2010 FSAP urged the United States to further centralize and federalize insurance supervision. The next assessment could very well view the creation of the Federal Insurance Office and the Federal Reserve's increased role in insurance supervision as perhaps only modest progress toward ever more centralized insurance supervision.

These activities will take place against the backdrop of Transatlantic Trade and Investment Partnership, a trade agreement to be negotiated between the European Union and the United States. European negotiators have persistently sought to include financial regulatory harmonization in TTIP,

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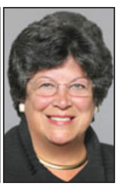
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although U.S.Treasury Secretary Jack Lew has stated that including financial regulatory harmonization in TTIP is not acceptable to the United States. European Union insurers will also be preparing for the phased implementation of Solvency II beginning in 2016. Originally slated for implementation in 2012, Solvency II had been delayed in EU negotiations until a final deal was reached in November 2013.

Federal

The Federal Reserve has now applied for IAIS membership in its capacity as the consolidated supervisor of United States insurance groups designated systemically important by the U.S. Financial Stability Oversight Council. Many will be watching to see if this is a portent for the Federal Reserve importing FSB-endorsed, IAIS-developed supervisory standards to the United States or whether the Federal Reserve will instead use its influence to seek to align international standards with U.S standards.

While careful observers wait to see how the Federal Reserve defines the enhanced supervision to be applied to the insurers it supervises, those same careful observers are awaiting guidance from the Federal Deposit Insurance Corporation on the resolution of insurers under Dodd-Frank, Title II. Insurance SIFIs, like all SIFIs, must prepare and file "living wills" that detail how they would be resolved. Dodd-Frank preserves the state insurance insolvency system but allows the FDIC a role in the resolution of the consolidated holding company.

To date the FDIC has given no guidance how it envisions this process to work, but such guidance is anticipated in the coming year so that insurance SIFIs can comply with the Dodd-Frank mandate.

Federal Insurance Office.

While the FIO does not have a supervisory role, its December 12, 2013, Report "How to Modernize and Improve the System of Insurance Regulation in the United States" openly envisions a greater Federal role in insurance supervision. Released as policymakers were leaving Washington for the holidays, the FIO Report will no doubt be the most referenced, discussed and debated insure public policy document of 2014 and many years to come. Of no less importance, FIO is also poised to impact policy through its participation for the first time in the reauthorization of the Terrorism Risk Insurance Act.

The Terrorism Risk Insurance Act. Last reauthorized in 2007, TRIA is set to expire on Dec. 31, 2014, unless extended by Congress. TRIA was enacted following the 9/11 terrorist attacks to address the near complete withdrawal of private terrorism coverage and provides commercial property/ casualty insurers access to a federal backstop for certain large terrorism events.

The trade-off for the backstop is that insurers of certain "covered lines" must make coverage available for losses resulting from certified acts of terrorism.

The House Financial Services Committee and the Senate Banking Committee have already held hearings on reauthorization.

The House and Senate committees may approach TRIA from different perspectives, but their inquiries will likely start by asking whether the private market can take on more terrorism risk and what the possible impact would be were TRIA to expire. The 2005 reauthorization resulted in an increase in insurers' deductibles and dropping some lines from the program.

These steps were intended to start weaning the market from a public backstop. If history is a guide, those in favor of greater private market involvement could press for different TRIA triggers, higher deductibles and more aggressive recoupment provisions. A bill is anticipated to be released and acted on in the House in the first quarter of 2014. How quickly and in what form the Senate addresses TRIA remains to be seen.

National Flood Insurance Program. In 2013, Congress reacted to constituent and state/local government complaints about the series of rate increases mandated when Congress reauthorized the NFIP in 2012. The rate increases, intended to end rate subsidies and relieve the beleaguered 40-year-old program of its $20 billion debt, enjoyed considerable bipartisan and bicameral support until homeowners began receiving notice of new or increased flood insurance premiums required under the legislation their members of Congress supported only a year ago. Congress has a long history of supporting fiscally responsible NFIP reforms while not wanting flood insurance requirements or rates to increase for their constituents. Serious re-examination of NFIP usually follows major flooding events and the program will be beset by this fundamental tension regardless of the compromises that are reached.

The Volcker Rule. Section 619 of Dodd-Frank—known as the Volcker Rule—generally prohibits any insurer that is a "banking entity" from (a) engaging in proprietary trading, or (b) investing in or sponsoring hedge funds and private equity funds ("covered funds"), subject to enumerated exceptions for "permitted activities." A "banking entity" includes any insurer that is an affiliate of an insured bank or thrift.

The final Volcker rule, adopted on December 10, 2013, is a significant improvement on the proposed rule with respect to its treatment of regulated insurers. The final Volcker rule exempts proprietary trading by a regulated insurer for the insurer's general account and separate accounts so long as the trading is conducted in compliance with applicable State investment law, regulations and written guidance, and the appropriate Federal banking agencies have not jointly determined that a particular law, regulation, or written guidance is insufficient to protect the safety and soundness of the banking entity or the financial stability of the United States. The final rule also clarifies that regulated insurers may sponsor and acquire interests in unregistered separate accounts, so long as no banking entity (other than the insurer that establishes the separate account) participates in the account's profits and losses.

Certain BOLI separate accounts are permitted under the final Volcker rule, subject to anti-abuse restrictions.

Application of Derivatives/Swaps Rules to Insurers. The definition of "swap" contained in Dodd-Frank is very broad and, arguably, includes agreements, contracts and transactions that traditionally have not been considered swaps. This is particularly true with respect to insurance.

In July 2012, the Securities and Exchange Commission and the Commodity Futures Trading Commission adopted final rules to further define the term "swap." As part of these final rules, the commissions adopted an "insurance safe harbor" to clarify that traditional insurance products are not swaps.

However, insurers must carefully analyze their products to determine whether or not they actually fall into the insurance safe harbor.

For example, direct insurance written for U.S. persons by certain commercial insurance companies and captive insurance companies located outside of the U.S. may be considered a "swap."

To the extent that insurance products are deemed swaps, such products would be subject to real-time reporting obligations and myriad other Dodd-Frank requirements, which include mandatory central clearing, electronic trade execution, record-keeping and reporting obligations. While these requirements are in effect at this time, the rules mandating that swap participants post margin in connection with their swap transactions are expected to be finalized in 2014. Insurance companies must also be mindful of derivatives regulation coming into effect in other jurisdictions where they conduct business and determine whether additional compliance measures are needed.

National Association of Registered Agents and Brokers Act. Congress will continue its work on the National Association of Registered Agents and Brokers Reform Act of 2013. The bill would create a private, not-for-profit corporation to serve as an interstate clearinghouse for non-resident producer licensure.

An approved NARAB member would be able to use the clearinghouse for non-resident licenses in any other state, while state insurance departments would retain their regulatory jurisdiction over key areas, including resident licensing, fees, consumer protection, market conduct and unfair trade practices.

National

NAIC Solvency Modernization Initiative. The NAIC's Solvency Modernization Initiative began in June 2008 and continues to affect key components of solvency regulation, including capital requirements, governance and risk management, group supervision, statutory accounting and financial reporting and reinsurance. In 2013, significant SMI milestones were reached, such as the adoption of the Holding Company Act Amendments as a state accreditation standard (effective Jan. 1, 2016) and consideration of the Own Risk and Solvency Assessment Model Act as a state accreditation standard.

Most notably, the ultimate controlling person of insurers domiciled in states that have adopted the Holding Company Act Amendments will be required to file an "enterprise risk report" (Form F) annually, with the first reports due April 30, 2014. These reports must identify, to the best of the ultimate controlling person's knowledge and belief, the material risks within the insurance holding company system that could pose enterprise risk to the insurers. A Corporate Governance Annual Filing, intended to serve as a companion to the ORSA and enterprise risk report, is under development for initial filing in 2016.

Additionally, changes in state reinsurance collateral requirements continue to gain traction as a result of SMI. As reported by NAIC staff at the 2013 summer national meeting, reduced reinsurance collateral provisions had been adopted by 18 states, representing approximately 53% of the total U.S. domestic insurance premium. These measures permit U.S. ceding insurers to take full credit for reinsurance ceded to qualified non-U.S. reinsurers based upon less than 100% collateralization (which has been historically required). The staff also reported that, based on pending legislation, reduced collateral legislation is expected to be enacted in states representing 70% to 75% of total U.S. domestic insurance premium by year-end 2014.

Principles-Based Reserving. A Valuation Manual containing a life insurance principles-based reserving methodology was adopted by the NAIC at the end of 2012, allowing PBR to move forward to state legislatures after a decade of work. Opposition to PBR, however, remains strong, particularly in key states.

PBR will not be implemented until the amended Standard Valuation Law is adopted by 42 states and state adoption reflects 75% of total life insurance premium written in the United States. This means that New York and California, two of the most vehement objectors to PBR, and which have large volumes of life insurance premium written in their states, could, with one other state, derail the process.

In September 2013, New York allowed the expiration of principles-based guidelines involving certain life products and repeated its call for state regulators to halt pursuit of principles-based reserving. The NAIC has stated that it will continue working to develop critical components for PBR, including a peer review process intended to help regulators refine the new system.

Tax Highlights

Foreign Account Tax Compliance Act. The IRS issued Notice 2013-69 in October 2013, describing its intention to update and amend the final FATCA regulations relating to non-financial foreign entities.

One expected regulatory change allows direct reporting to the IRS by NFFEs of U.S. 10% owners on Form 8966, thus allowing a property/casualty NFFE that is not part of a publicly traded group to avoid reporting such information to its U.S. insureds and other withholding agents and to be characterized as an excepted NFFE.

Federal Excise Tax. Cross motions for summary judgment have been filed in the *Validus Reinsurance Ltd. v. U.S.* tax refund case in U.S. District Court for the District of Columbia, in which the plaintiff has challenged the imposition of the cascading federal insurance excise tax.

Insurance Characterization. A number of federal tax cases involving insurance characterization are pending. Two cases have been tried in U.S. Tax Court, and briefs have been filed (*Rent-A-Center, Inc. and Affiliated Subsidiaries v. Commissioner and Securitas Holdings Inc.* and *Subsidiaries v. Commissioner*).

Additionally, a case has been filed in U.S. Tax Court involving the IRS' assertion on audit that residual value insurance was not insurance for federal tax purposes (*R.V.I. Guaranty Co. Ltd. and Subsidiaries v. Commissioner*).

State Activity. The trend continues across the country of state tax authorities attempting to impose corporate franchise or income tax on insurance companies not licensed in the state.

Other Matters of Interest

Increased Interest by Insurers in Alternative Investments. The continuing low interest rate environment is fostering interest in alternative, less traditional investments to enable insurance companies to maximize returns and support product crediting rates.

Investment sectors such as timber, energy, entertainment, industrial products and construction, which traditionally represent a relatively small portion of insurers' invested assets, may become increasingly attractive. BR