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SPECIAL BULLETIN

NAIC Updates – January 2018

Proposed Revisions to Model Regulation #275

The Annuity and Suitability (A) Working Group of the NAIC Life Insurance and Annuities (A) Committee held its most recent open meeting on Sunday, December 3, 2017 during the NAIC 2017 Fall National Meeting in Honolulu, Hawaii. The Working Group was charged with reviewing the *Suitability in Annuity Transactions Model Regulation #275* ("Model #275") and, during the meeting, introduced several proposed revisions. Model #275 was adopted to "set standards and procedures for suitable annuity recommendations, and to require insurers to establish a system to supervise recommendations so that the insurance needs and financial objectives of consumers are appropriately addressed." In drafting the proposed revisions, the Working Group was mindful of the need to have the revised Model #275 successfully passed in each state "without adversely affecting the ability of consumers to plan and have available to them the appropriate annuity products for their retirement needs."

The Working Group exposed the proposed revisions for public comment, with a deadline of January 22, 2018. The Working Group plans to review all comments, and to prepare a further revised model for submission to the Life Insurance and Annuities (A) Committee for its consideration and adoption at the NAIC 2018 Spring National Meeting. The revisions proposed include the following:

Best Interest Standard

The Working Group's proposed revisions introduce a new "best interest" standard, noting that in some instances, an annuity product could be suitable for a consumer, yet not in the consumer's best interest. The revisions do not replace the concept of suitability, instead treating it as a relevant factor in the best interest formulation. The standard is incorporated in several places, including the title of Model #275, which would be updated to the "Suitability and Best Interest Standard of Conduct in Annuity Transactions Model Regulation." In addition, the revisions include a definition of "best interest," developed from language in the U.S. Department of Labor's ("DOL") fiduciary rule, in an effort to create a uniform standard of care across the entire regulated community. Thus, Section 5B "Definitions" of Model #275 would be revised to include "Best Interest" as follows:

> "Best interest" means, at the time the annuity is issued, acting with reasonable diligence, care, skill and prudence in a manner that puts the interest of the consumer first and foremost.
>
> "Best interest" does not mean a resulting recommendation is the least expensive annuity product, or the annuity product

> with the highest stated interest rate or income payout rate, available in the marketplace at the time of the annuity transaction. "Best interest" also does not mean the recommendation is the single "best" annuity product available in the marketplace at the time of the annuity transaction, but based on the insurance producer's judgment acting with reasonable diligence, care, skill and prudence, the producer believes the recommendation is in the best interest of the consumer.

Although some Working Group members felt that the language of the definition was too broad, others noted that individual states can deviate from the model to suit the state's particular needs. Notably, New York's Department of Financial Services ("DFS") has already issued a proposed amendment to its *Suitability in Annuity Transactions* regulation, 11 NYCRR 224, to incorporate its own, similar, "best interest" standard. The amendment, published by DFS on December 27, 2017, would expand application of the New York regulation to include recommendations regarding in-force annuity contracts as well as life insurance policies, and would impose more expansive consumer disclosure requirements.

Duties of Insurance Producers

The proposed revisions to Model #275 impose certain requirements on an insurance producer, or an insurer when no producer is involved, in making an annuity recommendation.

First, the revised Section 6 ("Duties of Insurers and Insurance Producers") requires that, prior to making a recommendation, an insurance producer "(1) make reasonable efforts to obtain the consumer's suitability information; (2) evaluate the types of financial products which correspond to the consumer's disclosed suitability information and address the consumer's financial objectives; and (3) disclose to the consumer any limitations the producer or insurer has in regard to" the types of financial and annuity products that can be provided, as well as the scope of the producer's licenses and the scope of services provided. In addition, in making a recommendation, the insurance producer or insurer must make several disclosures, including (1) all material conflicts of interest; (2) the percentage of cash compensation above 3% that the producer would receive as a result of a contract for services advising or selling the recommended annuity; and (3) the bases of the annuity recommendation.

Next, a newly inserted Section 7 ("Non-Cash Compensation Disclosure Requirement") requires disclosure of any non-cash compensation tied to the sale of annuities that exceeds the value of $100/year, including, but not limited to, "gifts, meals, trips, entertainment, prizes, marketing, and advertising."

Finally, a new Section 8 ("Prohibited Practices") mandates that an insurance producer or insurer: "(1) [s]hall receive no more than reasonable cash compensation in making a recommendation; (2) [s]hall not make any materially misleading statements regarding the annuity transaction; and (3) [s]hall not base a recommendation on the producer's or insurer's own financial interest."

Other Revisions

In addition to the broader revisions discussed above, the Working Group's draft updates Section 9 ("Insurance Producer Training") to include a new training topic regarding "financial exploitation of seniors and other vulnerable adults," and revises Section 11 ("Recordkeeping") to eliminate the optional nature of the section, and to require that all records and other information used in making an annuity recommendation, including disclosures made to the consumer, are maintained for 6 years.

Preliminary Comments

At the meeting of the Working Group during the Fall National Meeting, several interested parties provided initial feedback. The Center for Economic Justice ("CEJ") inquired whether the

proposed revisions are intended to impact the number of annuity product types and features that can be sold. The Working Group noted that the purpose of the proposed revisions is to eliminate inappropriate business practices in the annuity space, but that the revisions are nonetheless likely to have some impact on annuity sales, particularly if non-cash compensation is limited. Both the American Council of Life Insurers ("ACLI") and the Independent Insurance Agents and Brokers of America ("IIABA") voiced support for a uniform standard of care across all of the regulated community, and advocated working with the SEC, DOL, and FINRA to accomplish that goal. The National Association of Insurance and Financial Advisors ("NAIFA") was favorable toward the best interest standard, but raised questions with regard to the compensation disclosure requirements. The Working Group explained that the 3% threshold included in the cash-compensation disclosure requirement was intended to act as a safe harbor for insurance producers, so that compensation under that threshold would not have to be examined for each annuity sale. The Working Group emphasized that the proposed revisions are simply an initial draft, and that they are open to adjusting the threshold percentage if another number is more appropriate. Finally, the Insured Retirement Institute ("IRI") noted that it was unclear how insurers would determine the compliance of independent insurance producers, as opposed to captive agents, with certain provisions of the draft, and IIABA felt that several of the draft's provisions would be controversial in many states.

Status of Covered Agreement Between EU and U.S.

The NAIC Reinsurance (E) Task Force ("RTF") held its most recent open meeting on Sunday, December 3, 2017 during the NAIC 2017 Fall National Meeting in Honolulu, Hawaii. During the meeting, the RTF heard a status report on the Bilateral Agreement Between the European Union and the United States of America on Prudential Measures Regarding Insurance and Reinsurance ("Covered Agreement"), which was executed by the United States and the European Union on September 22, 2017. The Covered Agreement will "eliminate reinsurance requirements for EU reinsurers that maintain a minimum amount of own funds equivalent to $250 million and a solvency capital ratio (SCR) of 100% under Solvency II," and allow U.S. reinsurers to do business in the EU without local presence so long as they "maintain capital and surplus equivalent to €226 million with an RBC of 300% of Authorized Control Level."

NAIC's Process for Implementing the Covered Agreement

At its Fall Meeting, the RTF noted that now that the Covered Agreement has officially gone into effect, U.S. states have "five years to implement its reinsurance provisions or face potential preemption by the Federal Insurance Office," which has the authority, under the Dodd-Frank Wall Street Reform and Consumer Protection Act, 12 U.S.C. § 5301 *et seq.* ("Dodd-Frank Act"), to issue determinations preempting state laws that it determines are inconsistent with the terms of the Covered Agreement. With a relatively tight timeline of only 60 months to implement the requirements of the Covered Agreement, the RTF and the NAIC at large have begun to discuss the appropriate approach to take with regard to implementation. For instance, the International Underwriting Association of London ("IUA") proposed an approach where "collateral would be reduced by 20% each year of the 60-month period, causing it to reach 0% at the end of the five years." The RTF is soliciting opinions and ideas on how states should address the Covered Agreement, noting that "there are several options for implementation of the Covered Agreement and that the [RTF] wants input from all interested parties and state insurance regulators that are interested in participating in the process." Specifically, the RTF is seeking perspectives on management of the risks to U.S. ceding companies created by the Covered Agreement, as well as treatment of Qualified Jurisdictions under the

Covered Agreement, including what additional "guardrails" might be necessary if the NAIC determines that Qualified Jurisdictions should be afforded the same treatment as EU reinsurers under the Covered Agreement.

The RTF has scheduled a public hearing on February 20, 2018, in New York City, specifically devoted to the reinsurance aspects of the Covered Agreement. In anticipation of the hearing, the RTF requests specific comments on the following approaches to reinsurance collateral reform:

- Amending the Credit for Reinsurance Model Law (#785) and the Credit for Reinsurance Model Regulation (#786) to eliminate reinsurance collateral requirements for EU-based reinsurers meeting the conditions of the Covered Agreement.
- Extending similar treatment to reinsurers from other jurisdictions covered by potential future covered agreement(s) that might be negotiated pursuant to the [Dodd-Frank Act].
- Providing reinsurers domiciled in NAIC Qualified Jurisdictions with similar reinsurance collateral requirements.
- Considering changes to the criteria for evaluating whether a jurisdiction should be a Qualified Jurisdiction.
- Considering additional "guardrails" relative to U.S. ceding companies, such as changes to the risk-based capital (RBC) formula or new regulatory approaches to help address the increased financial solvency risks caused by the elimination of reinsurance collateral.
- Any other considerations to weigh as part of the states' implementation of the Covered Agreement.

All comments are due by February 6, 2018.

Treatment of Qualified Jurisdictions Under the Covered Agreement

At its Fall Meeting on December 3, 2017, the RTF heard the report of the Qualified Jurisdiction (E) Working Group. At the 2017 Summer National Meeting, the Working Group was directed to discontinue work on its report on the implementation of Solvency II by the European member-states, given the likelihood that the Covered Agreement would go into effect. However, the Working Group was charged with performing a re-evaluation of all seven Qualified Jurisdictions before the current designations expire on December 31, 2019.

The Covered Agreement includes a five-year grace period for U.S. states to come into compliance. Accordingly, the states now have 60 months to adopt reinsurance reforms removing collateral requirements for EU reinsurers that meet the prescribed consumer protection conditions, and until the states have done so, the Qualified Jurisdiction status of the EU member states will remain relevant. The designation as a Qualified Jurisdiction is valid for 5 years, and all seven current Qualified Jurisdictions (Bermuda, Japan, Switzerland, France, Germany, Ireland, and the UK) were approved as of January 1, 2015. As such, each must be re-evaluated no later than December 31, 2019. Because the five-year compliance period of the Covered Agreement will still be in effect at that time, the Qualified Jurisdiction status of all seven nations, including those in the EU, remains relevant.

In discussing the NAIC's plans for implementing the Covered Agreement, representatives of organizations operating in Qualified Jurisdiction countries, including Swiss Re, Zurich Insurance Group, International Underwriting Agency, Lloyd's, the Association of Bermuda Insurers and Reinsurers ("ABIR"), and the General Insurance Association of Japan ("GIAJ"), as well as American reinsurers, the Reinsurance Association of America (RAA) and Lloyd's of America, spoke in favor of extending the benefits of the Covered Agreement to the existing Qualified Jurisdictions. Those in support emphasized the importance of maintaining a level playing field for all reinsurers, and advocated for expeditious implementation,

such that the Qualified Jurisdictions would not need their own covered agreements.

Reinsurance Collateral Ratings – *Credit for Reinsurance Model Regulation* (#786)

During its Fall National Meeting on December 3, 2017 the RTF heard an update from the Reinsurance Financial Analysis (E) Working Group regarding an issue referred to the Working Group during an RTF conference call held on June 13, 2017. The Working Group had been asked to consider Kroll Bond Rating Agency ("Kroll") as an acceptable rating agency for purposes of certifying reinsurers under Model #786 (Credit for Reinsurance Model Regulation), which provides that "[a]cceptable ratings agencies include [. . .] Standard & Poor's; Moody's Investors Service; Fitch Ratings; A.M. Best Company; or any other Nationally Recognized Statistical Rating Organization" (NRSRO).

"Model #786 provides that the assuming insurer must maintain financial strength ratings from two or more rating agencies deemed acceptable by the commissioner. . . . However, Model #786 does not provide a procedure for selection of a rating agency, either by a state or the NAIC, that has not been specifically designated in the regulation, or what collateral tier to assign its ratings under Section 8B(4)(a) of the model regulation." Thus, in order to deem Kroll an acceptable rating agency under Model #786, several questions needed to be addressed.

The Working Group first needed to determine the applicable tiers that would correspond with a given NRSRO's ratings under Model #786's "Secure 1 to Vulnerable 6" rating system. The current regulation provides for specific tiers for each rating issued by an NRSRO and the Working Group would need to determine the applicable tiers for any new rating agency. Moreover, the Working Group needed to devise a means of providing uniform guidance to the states on accepting a rating agency that is not specifically defined within Model #786, absent revisions to Model #786.

The Working Group met via conference call on September 12, 2017, in regulator-to-regulator session, and determined that "differing interpretations of 'any other Nationally recognized Statistical Rating Organization' by the states could lead to an inconsistent application of secure levels assigned to the certified reinsurer in determining the amount of collateral held." As such, the Working Group determined that the most logical course was to modify the *Uniform Application Checklist for Certified Reinsurers* to include Kroll, and to integrate Kroll into the matrix of ratings and collateral levels for certified reinsurers. The RTF met via conference call on November 1, 2017, and at that time agreed to expose the Working Group's recommendation for a 30-day comment period ending on December 1, 2017.

At the RTF's Fall Meeting on December 3, 2017, the Working Group noted that two comment letters had been received in response to the recommendation. The first, from the ACLI, voiced agreement with the Working Group's recommendation to integrate Kroll into the *Uniform Checklist* and ratings matrix. The second, from the Wisconsin Office of the Commissioner of Insurance, noted that the term "or any other Nationally Recognized Statistical Rating Organization" "is not technically correct as there are NRSROs which are not registered with the SEC to provide financial strength ratings on insurance companies," a requirement under Model #786. To address the concern, the RTF determined that the language in the *Uniform Application Checklist for Certified Reinsurers* should be updated to clarify that an NRSRO must be "recognized by the SEC to provide financial strength ratings on insurance companies." With that revision included, the RTF unanimously voted to adopt the Working Group's recommendation that states may consider Kroll Bond Rating Agency as an acceptable NRSRO for certified reinsurer purposes, and to adopt the revised *Uniform Checklist* and ratings matrix.

Investment Security Standards

Prior to the RTF's Fall Meeting in December 2017, the Task Force met via conference call on November 1, 2017. At that time, the RTF heard an update from the Reinsurance Investment Security (E) Subgroup. Since the 2017 Spring National Meeting, the Subgroup has met on several regulator-to-regulator calls to review an investment product, with the goal of "clarify[ing] the concept of 'investment security' for reinsurance collateral purposes under Model #785 [Credit for Reinsurance Model Law] and Model #786 [Credit for Reinsurance Model Regulation], and the concept of 'primary security' for XXX/AXXX captive reinsurance transactions under Model #787 [Term and Universal Life Insurance Reserve Financing Model Regulation]."

The Subgroup evaluated the investment product, and developed a recommendation "to assist the [RTF] in adopting standards that can be used when future requests to review and evaluate new investment products are received." At the 2017 Summer National Meeting, the RTF voted to expose the Subgroup's memorandum, including the majority recommendation, as well as the minority position, for a 30-day comment period.

The recommendation supported by the majority of the Subgroup included the following:

1. Individual investments should not be identified as suitable under Model #785 and Model #786. It was noted that where an investment is part of a Regulatory Transaction, such suitability identification "limits the commissioner's ability to evaluate the acceptability of the investment and prevents the commissioner from specifically approving or disallowing the investment."

2. "No security [should] be considered as Primary Security under Model #787 when the receipt of cash flows from the issuer of the investment is affected by the financial condition, actions, assets or obligations of the investment's holder, the holder's affiliates, or the holder's overall holding company group." Such securities are to be considered part of a Regulatory Transaction.

3. Regulatory Transactions must be "considered collectively with all other transactions involving affiliates, the overall holding company group, as well as with unaffiliated companies used as intermediaries between the insurance reporting entity, and affiliated entities or the overall holding company group."

4. "Securities considered part of a Regulatory Transaction shall not be considered SVO-listed or qualify as Primary Security."

At the RTF's November 1, 2017 meeting, the Subgroup noted that it had received one joint comment letter, from New York Life Insurance Company and Northwestern Mutual Life Insurance Company. The two companies expressed strong support for the "majority positions and recommendations outlined in the memorandum as they are sensible and prudent given the limited public information about the specific investment product reviewed by the Subgroup."

The joint letter went on to highlight the importance of the definition of "Primary Security," noting that it "is intended to ensure that when a captive is used, the life insurer sets aside high-quality assets in an amount that is equal, at a minimum, to the reserve level calculated under principle-based reserves. . . ." The letter urged that Model #787 would be undermined if companies were allowed to finance reserves with contingent assets, noting that assets considered "Primary Security" must be "unconditionally available to satisfy policyholder liabilities." Accordingly, the joint letter suggested an amendment to the second recommendation of the Subgroup's memorandum, in order to clarify that the exclusion from "Primary Security" applies whenever there is recourse to the insurer of its group. The proposed additional language appears in italics here:

> The Subgroup recommends that NO SECURITY be considered "Primary Security" when the receipt of cash flows from the issuer of the investment is impacted by the financial condition, actions, assets or obligations of the investment's holder, the holder's affiliates or the holder's overall holding company group, *or creates a right of recourse or reimbursement against any such person or its property*.

The Subgroup reviewed and approved the suggested language, and added it to the Subgroup's final memorandum containing the recommendations.

The RTF voted unanimously to adopt the memorandum of the Subgroup, as revised, and to issue related referrals to several other NAIC working groups and task forces.

Proposed Accreditation Standards

At the Spring National Meeting on April 9, 2017, the RTF considered a proposal that the new *Term and Universal Life Insurance Reserve Financing Model Regulation* (#787) (adopted in Fall 2016), be adopted by the NAIC as a new accreditation standard. Also known as the XXX/AXXX model regulation, Model #787 "establishes uniform, national standards governing reserve financing arrangements pertaining to term life and universal life insurance policies with secondary guarantees. Model #787 also includes provisions to ensure that funds backing these captive reinsurance transactions, which consist of primary security and other security, are held in the forms and amounts that are appropriate." The RTF prepared a draft accreditation standard, and exposed it for a 30-day comment period.

At the Summer National Meeting on August 7, 2017, the RTF considered the comments received, and unanimously adopted the draft accreditation standard, with certain revisions. The RTF then made a recommendation to the Financial Regulation Standards and Accreditation (F) Committee ("FRSA") to adopt the draft accreditation standard, with an expedited effective date of January 1, 2020.

The FRSA held its most recent open meeting on Saturday, December 2, 2017 at the Fall National Meeting in Honolulu, Hawaii. During the meeting, the FRSA considered the recommendation from the RTF to adopt the draft accreditation standard for Model #787. One joint comment letter was received during the most recent exposure of the draft, from New York Life Insurance Company and Northwestern Mutual Life Insurance Company. The joint letter urges the FRSA to adopt Model #787 as an accreditation standard, as drafted by the RTF, noting that "this step strengthens the state-based system of insurance regulation, ensuring consistent national adoption of the NAIC's framework for regulating the solvency of XXX and AXXX life insurer captives." At the Fall National Meeting, the ACLI also voiced support for including Model #787 as an accreditation standard.

The FRSA, however, determined that adoption of Model #787 as an accreditation standard might be premature, given the unknown impact the Covered Agreement will have on credit for reinsurance. Members of the FRSA anticipate that the Credit for Reinsurance Model Law (Model #785) and the Credit for Reinsurance Model Regulation (Model #786) will need to be adjusted to account for changes implemented by the Covered Agreement. As such, the FRSA felt it was appropriate to defer its determination regarding Model #787, which in some states is dependent on Model #785, until after any upcoming amendments to the credit for reinsurance models are complete.

In the interim, the FRSA noted that because most states have adopted *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* (AG 48), those states still have

the protections in place that these changes were envisioned to guard against.

Status of VM-22

At its Fall Meeting on November 30-December 1, 2017, the Life Actuarial (A) Task Force ("LATF") heard from the VM-22 (A) Subgroup, which had been charged with developing a principles-based reserve (PBR) methodology for non-variable annuities. At its Spring Meeting in April 2017, LATF had adopted the proposed VM-22 (Maximum Valuation Interest Rates for Income Annuities), which "provides the methodology for determining valuation interest rates for income annuities and is designed to be more responsive to the economic environment than the current interest determination method." The new process will calculate rates monthly, rather than annually, and jumbo contract (>$250 million) rates will be contract-specific and set based on daily interest rates. Rates will be calculated by NAIC staff and posted on the NAIC website.

VM-22 went into effect on January 1, 2018. At LATF's Fall Meeting, the VM-22 (A) Subgroup explained that the valuation interest rates for non-jumbo contracts will be published by the NAIC on a quarterly basis, while the rates for jumbo contracts will be published daily. Though the Subgroup noted that it did not intend to publish the weights applied to the quarterly Treasury rates underlying the valuation interest rates, it agreed to consider publishing the weights in response to a comment from Pacific Life, noting that such information would be helpful for pricing actuaries.

The Subgroup is also working to develop valuation interest rates for the development of fixed annuities outside the scope of VM-22. The Subgroup is testing potential methodologies to determine the appropriate annuity forms and options to use as an underlying structure for such annuities. The Subgroup reported that the objective of having convergence between fixed annuities and variable annuities has been complicated by the work currently being performed on *Actuarial Guideline XLIII—CARVM for Variable Annuities* (AG 43). Because AG 43's currently proposed framework is primarily based on separate account considerations, it is not easily adapted to the fixed annuity environment.

Finally, the Subgroup has noted that several questions about the applicability of VM-22 in specific situations have been raised by interested parties. For instance, the Subgroup has determined that guaranteed investment contracts are outside the scope of VM-22, but interest-only payouts may be within the scope. The Subgroup is unsure of whether a guaranteed lifetime withdrawal benefit ("GLWB") contract falls under VM-22. To address similar questions of scope and applicability, the VM-22 (A) Subgroup plans to compile a question-and-answer document that will be made publically available.

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