The insurance industry has a global reach. Insurers and reinsurers are critically important to the world economy. They assume and transfer all manner of risk across the globe, and serve as an enormous investor base for the world’s capital markets and beyond. Risk is increasingly shared globally among traditional and new market entrants. Risk generated in one part of the world is distributed immediately across multiple continents to other market participants, whether they be other insurers, reinsurers, private equity sponsors or capital market investors. The insurance industry is constantly evolving and requires regulatory regimes and market participants to adapt on a frequent basis. Regulatory issues arising in one market may influence the way in which similar regulatory concerns are addressed in other markets. To understand the insurance industry, one must have a solid understanding of global developments. We prepared this publication as a tool to assist readers in obtaining such understanding.

We realize that no one publication could provide adequate coverage to each and every recent global development without becoming cumbersome. Accordingly, this publication attempts to provide an overview of major legal and market developments in the global insurance industry arising over the past year. We have focused on developments in the United States, United Kingdom, European Union, Asia and other markets with intense insurance activity, such as Bermuda.

This review has been produced by the Insurance and Financial Services group of Sidley Austin LLP. Sidley is one of the world’s premier law firms, with 2,000 lawyers across 20 offices in North America, Europe and Asia Pacific. Sidley is one of only a few internationally recognized law firms to have a substantial, multidisciplinary practice devoted to the insurance industry. We have more than 85 lawyers devoted to providing both transactional and dispute resolution services to the insurance industry throughout the world. Our Insurance and Financial Services group has an intimate knowledge of, and appreciation for, the insurance industry and its unique issues and challenges. Regular clients include many of the largest insurance and reinsurance companies, their investors and capital providers, brokers, banks, investment banking firms and regulatory agencies for which we provide regulatory, corporate, capital markets, securities, mergers and acquisitions, private equity, insurance-linked securities, derivatives, tax, reinsurance dispute, class action defense, insolvency and other transactional and litigation services.

We hope you enjoy this edition of the Sidley Global Insurance Review.
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I. The Global Mergers and Acquisitions Market

A. NORTH AMERICAN MARKET

1. Introduction

Insurance industry mergers and acquisitions ("M&A") in 2017 was something of a mixed bag, with some sectors of the industry showing a notable uptick in deal activity and others remaining relatively anemic. In the life and health insurance space, the number of transactions increased by approximately 60% year-over-year, with 50 life and health M&A deals announced in the fourth quarter alone—the most prolific quarter in recent years. Aggregate life and health deal values also increased significantly, from US$4.42 billion in 2016 to US$7.78 billion in 2017, even before taking into account CVS Health Corporation’s ("CVS Health") proposed US$69.35 billion acquisition of Aetna, Inc. ("Aetna"), announced in December 2017. Last year’s deal activity in the property and casualty ("P&C") market, on the other hand, was not similarly robust—while the number of P&C deals remained relatively steady from 2016 to 2017, transaction valuations dropped from just over US$17 billion in 2016 to approximately US$8 billion in 2017 (although 2018 has already seen the announcement of American International Group’s ("AIG") proposed US$5.56 billion acquisition of Validus Holdings Ltd. ("Validus") and Kemper Corporation’s ("Kemper") proposed US$1.4 billion acquisition of Infinity Property and Casualty Corporation ("Infinity").

Several trends appear to underlie insurance M&A activity in 2017. Variable annuity transactions were prominent in 2017, apparently reflecting some selling insurers’ interest in achieving greater consistency and predictability in their financial performance by divesting blocks of business with a more volatile performance profile. Private equity-backed consortiums were the predominant purchasers in these transactions, in large measure because of their ability to hedge (on an economic basis) the risks inherent in variable annuity business without the short-term shareholder pressures that attend GAAP reporting, and, in a similar vein, their ability to manage significant mark-to-market earnings fluctuations. Although some of the established P&C insurers announced large transactions in 2017, trends were not as apparent in the P&C market, with the notable exception of private equity’s continued enthusiasm for run-off businesses. Also noteworthy in 2017 was the continued interest shown by large health carriers in other sectors, driven by a changing regulatory environment and an evolving healthcare market.

2. Life and Annuity Market

As we forecasted in last year’s edition of the Sidley Global Insurance Review, rising interest rates in 2017 appear to have stimulated renewed interest in certain life and annuity books of business. After a prolonged lull in transactions involving variable annuity blocks in recent years, the market for such deals awakened in earnest in the fourth quarter of 2017, led by two transactions in which insurers agreed to offload their run-off variable annuity business to private equity-backed buyer consortiums.

In December, the Hartford Financial Services Group, Inc. ("The Hartford") announced the sale of Talcott Resolution, its run-off life and annuity business, to an investor consortium led by Cornell Capital LLC, Atlas Merchant Capital LLC, TRB Advisors LP, Global Atlantic Financial Group, Pine Brook and J. Safra Group for just over US$2.0 billion. The Hartford will take a 9.7% ownership interest in the acquiring company. As part of the agreement, a considerable portion of fixed annuity, payout annuity and structured settlement business (approximately US$9.3 billion of ceded reserves) will be reinsured to a subsidiary of Global Atlantic Financial Group. The sale marks the culmination of The Hartford’s exit from its run-off life and annuity business, which The Hartford has announced will allow it to sharpen its focus on the continued growth of its P&C, group benefits and mutual funds businesses. The sale is expected to close in the first half of 2018.

Close on the heels of the Talcott Resolution deal came another sale of variable annuity business by a major insurer. This time it was Voya Financial, Inc. ("Voya"), which on December 21 announced an agreement to transfer substantially all of its closed-block variable annuity business to a group of investors including Apollo Global Management LLC, Crestview Partners LP and Reverence Capital Partners LP. Voya will take a 9.9% ownership interest in the acquiring company. As part of the deal, an estimated US$19 billion of fixed annuity business will be ceded to reinsurers subsidiaries of Athene Holding Ltd. In announcing the transaction, Voya noted that the deal would allow it to reduce its exposure to the risks associated with the closed-block variable annuity segment and to concentrate on its retirement, investment management and employee benefits businesses. The transaction is expected to close in the second or third quarter of 2018.

The Hartford’s sale of Talcott Resolution was not its only notable large transaction in 2017. In October, the Connecticut-based insurer announced the acquisition of Aetna’s U.S. group life and disability business for US$1.45 billion. The transaction closed in November, and it is expected to make The Hartford the second largest group life and disability insurer in the United States by premium volume.

A second large group benefits-related transaction was announced in January 2018, when Lincoln Financial Group ("Lincoln Financial") agreed to acquire Liberty Life Assurance Company ("Liberty Life") from Liberty Mutual Insurance Group for US$3.3 billion. Lincoln Financial plans to retain Liberty Life’s group benefits business but has agreed to reinsure the life and annuity business to a subsidiary of Protective Life Corporation for US$1.17 billion. The transaction is expected to close in the second quarter of 2018.

Continuing what was an active fall in the life insurance space, in early October 2017, an affiliate of Global Bankers Insurance Group, LLC ("Global Bankers") agreed to purchase Lincoln Benefit Life Company ("Lincoln Benefit Life") and certain other affiliated entities from Resolution Life, L.P. ("Resolution Life"). The deal marked the second time Lincoln Benefit Life has been sold in the last five years; it had been sold to Resolution Life by Allstate Life Insurance Company in 2013. The transaction, when consummated, would be the largest in Global Bankers’ history.

Two life insurance transactions discussed in previous editions of the Sidley Global Insurance Review involving Chinese acquirers continued to make headlines in 2017, demonstrating that the regulatory environment continues to be challenging for such buyers. In April, the pending sale of Fidelity & Guaranty Life (“F&G”) to Anbang Insurance Group Co. Ltd. (“Anbang”) was called off as a result of the Chinese buyer’s inability to secure approvals from insurance regulators in Iowa and New York. However, in May, F&G found a new deal partner in CF Corp., a special purpose acquisition company or “SPAC” that went public in May 2016. Investors in the transaction included funds affiliated with The Blackstone Group L.P. and Fidelity National Financial. The parties agreed to a deal valued at US$1.84 billion, plus the assumption of US$405 million of F&G’s existing debt. The transaction was completed in November 2017. The second transaction involved the October 2016 agreement by China Oceanwide Holdings Group Co., Ltd. to purchase all of the outstanding shares of Genworth Financial, Inc. (“Genworth”) for US$2.7 billion. As of this writing, the acquisition had yet to close; required approvals had not yet been obtained from the Committee of Foreign Investment in the United States (“CFIUS”) and from other regulatory authorities in the United States and China. In November 2017, the parties announced an extension of the transaction’s “drop dead” date to April 1, 2018 in order to address data security concerns raised by CFIUS. A joint application was refiled with CFIUS in February of 2018, which Genworth announced included an additional data security risk mitigation proposal that includes the use of a U.S. third-party service provider.

Other significant life insurance industry divestitures announced in 2017 include the May 2017 agreement by Transamerica (a subsidiary of Aegon) to reinsure approximately US$14 billion of run-off payout annuity and bank-owned/corporate-owned life insurance business to Wilton Re, and United Fire Group, Inc.’s September 2017 agreement to sell its life insurance subsidiary, United Life Insurance Company, to Kuvare US Holdings, Inc. for US$280 million, which is expected to close in the first half of 2018.

3. P&C Market

Although aggregate P&C transaction values were lower through most of 2017 compared to 2016 values, deal activity appeared to gain momentum in late 2017 and early 2018 as higher-value transactions emerged and interest in the acquisition of Bermuda-based companies continued. We examine some of the more notable P&C deals below.

In February 2017, Markel Corporation (“Markel”) announced its US$250 million acquisition of SureTec Financial Corporation, which closed in April 2017. Markel followed this deal with its US$919 million acquisition of State National Companies, Inc., which closed in November 2017 and was Markel’s largest insurance underwriter acquisition since the US$3.3 billion acquisition of Alterra Capital Holdings Ltd. in 2013.

Like Markel, Assurant Inc. (“Assurant”) has pursued operational growth through acquisitions. In October 2017, it announced its agreement to purchase The Warranty Group Inc. (“Warranty Group”) for approximately US$2.5 billion in a transaction expected to close in the first half of 2018. This would be Assurant’s largest acquisition to date as a public company, and it is expected to help Assurant maintain growth in its core vehicle protection services business. In addition, the deal would significantly expand Assurant’s international footprint—Warranty Group business has operations in over 35 countries.

In a transaction designed to generate synergies, Toronto-based Intact Financial Corporation (“Intact”) in September 2017 acquired OneBeacon Insurance Group, Ltd. for US$1.7 billion in cash. Intact indicated that the transaction would pave the way for it to expand its U.S. presence and become a leader in specialty insurance for small to midsized businesses.

In January 2018, AIG made headlines with the announcement of its agreement to purchase Validus for US$5.6 billion in cash (representing a premium of about 45% over the target’s closing share price at the end of the preceding week), and Kemper soon followed with the February announcement of its agreement to acquire Infinity in a cash and stock deal valued at approximately US$1.4 billion. In addition, there seemed to be a resurgence of interest in Bermuda-based run-off businesses on the part of private equity funds. Examples include the proposed acquisition by Apollo Global Management LLC of a majority stake in Catalina Holdings (Bermuda) Ltd. (a transaction expected to close in the first quarter of 2018) and Aquiline Capital Partners’ December 2018 acquisition (through its newly formed affiliate Armour Group Ltd.) of Bermuda-based Armour Risk Services (Bermuda) Limited. Private equity activity in the P&C space was not limited to Bermuda-based run-off business, however. AmTrust Financial Services, Inc. (“AmTrust”), for example, announced in November a definitive agreement to transfer the majority of its equity interest in certain U.S.-based fee businesses to Madison Dearborn Partners, a private equity firm. The deal values the transferred business at US$1.15 billion. Then, in early March 2018, AmTrust announced that it had reached agreement with private equity firm Stone Point Capital L.L.C. and the family that controls a significant portion of AmTrust to take AmTrust private.

4. Health Market

Legislative uncertainty and political volatility continued to cloud the transactional landscape for health insurance giants in 2017. In February, Aetna called off its prospective US$37 billion acquisition of Humana Inc. (“Humana”) after a federal judge enjoined the consummation of the transaction. Amidst the enhanced regulatory scrutiny and political turmoil surrounding the announcement of the planned merger, Aetna reported that it would pay a US$1 billion fee to terminate the agreement. The termination of the Aetna-Humana agreement came just before another federal judge blocked the proposed merger between Anthem Inc. and Cigna Corp. That deal would have resulted in the creation of the largest health insurer in the country, continuing an unprecedented wave of consolidation in the U.S. healthcare industry.

These failed mergers notwithstanding, 2017 saw the continued integration of healthcare services in what is becoming an industry-wide trend towards relationships between insurers and other participants in the healthcare industry. The largest such transaction
was announced in December, when CVS Health, the drugstore giant, agreed to acquire Aetna, one of the largest U.S. health insurers, for US$69 billion.

In another high-profile example of a health insurer seeking to extend its reach into other areas of the healthcare industry, Humana, TPG Capital ("TPG") and Welsh, Carson, Anderson & Stowe ("WCAS") announced their agreement to acquire Kindred Healthcare ("Kindred") for a total consideration of US$4.1 billion. TPG and WCAS plan to operate Kindred's long-term care hospitals and inpatient rehab facilities, while Humana plans to control Kindred's hospice, home health and community care business through a separate entity. In announcing the proposed acquisition, Humana explained that it sought to integrate its outpatient services with its Medicare plans, and that it expects the transaction to bolster Humana's integrated care delivery strategy. The transaction is expected to close during the summer of 2018.

The flurry of major healthcare industry deals continued in December 2017, when UnitedHealth Group ("UnitedHealth"), the nation’s largest health insurer, announced its agreement to acquire DaVita Inc.’s primary and urgent care services for US$4.9 billion. The deal would add nearly 300 clinics and 35 urgent-care centers to Optum, UnitedHealth’s non-insurance division.

Health insurers also continued to seek access to new Affordable Care Act ("ACA") marketplaces through M&A. Centene Corporation’s proposed US$3.7 billion acquisition of New York-based Fidelis Care (expected to close in the first quarter of 2018) was a prominent example—the announced intent of the acquisition was to provide Centene with broader access to New York’s ACA marketplace, mirroring Centene’s strategy when it acquired Health Net, Inc. in 2015 in order to expand its presence in California’s Medicaid and ACA markets.

5. Outlook for 2018

Private Equity Buyers. The growing enthusiasm exhibited by private equity purchasers to acquire insurance assets in recent years showed no sign of abating in 2017, and we expect them to remain prominent participants in 2018. In larger transactions, putative acquirers that have the ability to raise capital quickly or that have established committed funding vehicles to provide financing will likely be at an advantage to win business over those without such financing capabilities.

Variable Annuity Business. Market conditions in 2018, including rising interest rates and increased market volatility, may provide a more propitious environment for dealmaking in the variable annuity market. Insurers that are sensitive to such conditions (especially publicly held insurers that must reckon with short-term shareholder pressures) could seek to limit their exposure to variable annuity business, creating new acquisition opportunities for private equity-backed (and other) buyers that have different deal-making imperatives and constraints.

Tax Reform. The passage of the Tax Cuts and Jobs Act ("TCJA") is likely to continue to influence the insurance M&A market in ways that are difficult to predict. The TCJA’s reduction of the marginal tax rate from 35% to 21% will generally reduce the effective tax rates of domestic corporations and could change competitive dynamics between insurers domiciled in the United States and those based abroad. New deal structures may also emerge in order to minimize the impact of taxes under the new rules. Additionally, while the TCJA’s changes to the passive foreign investment company ("PFIC") rules will resolve some, but not all, of the uncertainty in this area, it may also force companies to restructure or seek out new strategic partners or transactions. Finally, the new base erosion and anti-abuse tax is expected to have material consequences for U.S. companies with affiliated foreign reinsurers. The uncertain impact the TCJA will have on M&A activity in 2018 is worth monitoring.

Chinese Acquirers. As noted in previous editions of the Sidley Global Insurance Review and as evidenced by the developments in the F&G and Genworth transactions in 2017, regulatory risk and closing certainty remain key considerations in transactions involving Chinese acquirers and U.S. insurance company targets. Sellers will continue to require additional diligence with respect to funding and approvability, as well as strong contractual protections. It remains to be seen whether and to what extent the marketplace (including from a contractual standpoint) adapts to such challenges, and whether the willingness of Chinese buyers to participate in the U.S. market (and of sellers to entertain deals with them), will be adversely affected by the chastening experiences of 2017, increased tightening of Chinese governmental currency and outbound investment controls. These concerns are likely to intensify following the February 2018 announcement by the China Insurance Regulatory Commission that the country’s main financial regulators would take temporary control of Anbang, and that the company’s founder, Wu Xiaohui, would be removed as chairman and charged with fraud and embezzlement. According to the announcement, the government’s control could end within a year if asset disposals are completed, strategic shareholders inject capital and the company is stable. While Anbang will remain a private company, government control could be extended by as much as another year if necessary.

Investment in “Insurtech” (i.e., the use of technology, big data and predictive analytics to create efficiencies in insurance operations). In last year’s edition of this publication, we identified technology-based business models as a rising deal driver in 2016. That trend continued in 2017, with insurance companies showing strong interest in investing in financial and insurance technology companies, especially those involving digital marketing platforms, digital sales tools and the use of data science and analytics competencies. This interest appears to be driven in part by insurers’ search for more efficient ways to generate, underwrite and administer business in response to shifting consumer demands and market inefficiencies. We see no reason for this interest to abate in 2018.

Market Disruptors. As technology has assumed greater significance in the insurance industry, the barriers for non-traditional players with technological prowess and access to capital to seize market share have been lowered. Commentators have for some time viewed companies such as Amazon.com and Alphabet Inc. as potential new market entrants and disruptors, and in this regard, Amazon’s recent joint venture with JPMorgan Chase and Berkshire Hathaway bears watching. In January 2018, the three entities announced plans to form an independent healthcare company with a stated mission
to lower healthcare costs through technology and other solutions for nearly one million of the companies’ employees, with a view to expand this initiative into the broader U.S. market.

B. EUROPE

1. Introduction
Political uncertainty contributed towards 2017 being a relatively quiet year for European insurance M&A, particularly when measured by the volume of transactions compared to previous years. In particular, uncertainty around how the United Kingdom (“UK”) will conclude its exit negotiations from the European Union (“EU”) remains a key strategic consideration for European (re)insurers. For many of these, the focus in 2017 and into early 2018 has been on making arrangements for Brexit rather than pursuing M&A opportunities. In addition, the continuing soft market has resulted in many firms turning their focus towards internal capital optimization.

However, there were still a number of significant deals that were consummated in 2017, with notable activity in the sectors discussed below. We expect each of these sectors to remain active through 2018.

2. Run-off Market
The implementation of the Solvency II Directive (2009/138/EC) (“Solvency II”) on January 1, 2016 has resulted in increased activity in the run-off market, through share sales, portfolio transfers and reinsurance deals, and this trend has continued into 2018. The increased capital requirements under Solvency II have forced (re)insurers to assess whether or not to retain certain lines of business and the impact this will have on their core activities. In addition, with Brexit looming, many (re)insurers are deciding what to do with their closed books of business, and it is anticipated that there will continue to be strong levels of activity in the run-off market through 2018.

There were a number of notable transactions in the European run-off market in 2017. In the first half of the year, Enstar agreed to reinsure RSA’s UK legacy portfolio of approximately £800 million in net reserves (which will be followed by a transfer pursuant to Part VII of the Financial Services and Markets Act 2000), and AXA announced that it would be transferring all of its UK, Channel Islands and Isle of Man employers’ liability and public liability policies issued prior to January 1, 2002 to Riverstone. In addition, in April 2017, European run-off insurer, Darag, agreed to acquire the entire issued share capital of Ikano Försäkring AB, a Swedish insurer.

There was also a surge of activity towards the end of the year. For example, Compre announced in September 2017 that it had agreed to acquire AXA Insurance Ltd.’s participation in the RW Gibbons Pools from 1962 to 1964 and, in December 2017, agreed to purchase approximately US$353 million of non-life legacy liabilities from the UK branch of Generali. In addition, in November 2017, Zurich Insurance plc announced that it had entered into an agreement with Catalina Insurance Ireland DAC (“Catalina”) to transfer its German legacy medical malpractice book of business, representing approximately US$450 million in reserves, to Catalina, through a portfolio transfer to be sanctioned by the Irish High Court.

3. Insurtech
Over the past few years, investment in “insurtech” in Europe has grown substantially. While the size of the deals tends to be relatively modest, the insurance market saw a significant increase in the number of transactions involving insurtech companies over the course of 2017. Traditional (re)insurance companies have shown an increased interest in insurtech as a place to invest their capital as it has the advantage of providing a more consumer-centric approach and they see it as a good place (in comparison to other technology markets) to invest in the Internet of Things, distribution, data and analytics.

Indeed, many of the world's largest insurers, including Aviva, Allianz, MetLife and XL Catlin have already established venture capital funds with the intention of investing in startups in the insurtech market.

In early 2017, Aviva, through its venture capital fund, Aviva Ventures, led a Series A funding in Neos, a London-based tech firm founded in 2016. As well as offering insurance policies through a managing general agent (“MGA”) agreement with Munich Re, Neos offers customers cameras and other sensor technology around the home which can detect incidents such as break-ins or leaks and sends notifications directly to a consumer’s mobile.

In addition, The Travelers Companies, Inc. completed its acquisition of Simply Business from Aquiline Capital Partners, LLC, for approximately US$490 million. Simply Business is an insurance intermediary that is a provider of small business insurance policies in the UK, which it sells through online platforms for a number of insurance carriers.

Other notable 2017 transactions included XL Catlin’s partnership with Cytor, a UK-based insurtech company, and Allianz's US$96 million investment in BIMA (through its digital-focused investment arm, Allianz X), a Stockholm- and London-based microinsurer that serves low-income targets in emerging economies.

4. Private Equity
Private equity firms continue to show a strong interest in the European insurance sector. As well as investment in some of the more active M&A sectors, such as the insurtech and run-off markets, insurance agencies and brokers have also continued to attract significant interest from a private equity standpoint, as they tend to have steady cash flows, high client retention rates and strong revenues. For those private equity groups with a longer-term “buy and hold” strategy, investing in traditional (re)insurers has proven to be a successful strategy notwithstanding the capital-intensive nature of an investment in a risk carrier.

There were some notable deals in both the brokerage and traditional (re)insurance markets in 2017. On the brokerage side, Sovereign Capital agreed to back the management buy-out of Arachas Corporate Brokers, an Irish insurance brokerage. In addition, UK General, a MGA specializing in personal lines insurance, was acquired by J.C. Flowers and Co LLC. And, toward the end of 2017, a private equity firm, Inflexion, announced the double buy-out and subsequent merger of UK-based Bollington Insurance Brokers and Wilsons Insurance Brokers.
On the (re)insurer side of the market, Japan’s Sompo Holdings Inc. announced its agreement to sell its Lloyd's specialist insurance subsidiary, Sompo Canopus AG, for US$952 million to a private equity consortium led by Centerbridge Partners. In addition, Apollo Global Management, LLC announced its agreement to acquire a majority stake in Catalina Holdings (Bermuda) Ltd., the run-off insurance specialist. Both acquisitions are subject to regulatory approval and are due to close in the first half of 2018.

5. Lloyd’s

With its international network of licenses, the Lloyd’s market remains an attractive target for many (re)insurers looking to expand their global underwriting footprint. As the process for establishing a new Lloyd’s managing agent is relatively time consuming (usually at least two to three years), there is strong competition for those Lloyd’s platforms which are put up for sale. Given the degree of consolidation in the Lloyd’s market over recent years, there is now a scarcity of potential M&A targets among the established managing agency groups. This in large part led to 2017 being a relatively quiet year for Lloyd’s M&A. That said, there were nonetheless some notable transactions. These included the acquisition by Argo Group International Holdings Ltd. ("Argo") of Ariel Re, a global underwriter of insurance and reinsurance business, that primarily underwrites through Lloyd’s Syndicate 1910. As a result of the transaction, which closed in February 2017, Argo became one of the larger syndicates at Lloyd’s by stamp capacity.

In July 2017, Hannover Re acquired Argenta Holdings Limited, which owns Argenta Syndicate Management, Argenta Private Capital and a pro rata share of Lloyd’s syndicate Argenta Syndicate 2121. Then, in October 2017, Axis Capital acquired Lloyd’s syndicate Novae, for £468 million. The acquisition created a £2 billion insurer in London and one of the 10 largest (re)insurers at Lloyd’s.

II. The Global Alternative Risk Transfer and Capital Markets

A. LIFE & ANNUITY MARKET

Over the past few years, the majority of the activity within the risk transfer market of the life insurance sector focused on perceived excess reserve requirements associated mainly with blocks of level premium term insurance subject to Regulation XXX ("Regulation XXX" or "XXX") and a limited amount of universal life products with secondary guarantees subject to Actuarial Guideline XLVIII (AXXX) ("Regulation AXXX" or "AXXX"). Although the debate around captive reinsurance transactions remained an ongoing theme for the life insurance industry, these techniques have often been featured in M&A transactions, such as whole company transfers, related business line divestitures and block acquisitions through reinsurance transactions.

1. The State of the Reserve Financing Market
   a. PBR Adoption Update

As discussed in last year’s publication of the Sidley Global Insurance Review, on June 10, 2016, the Executive and Plenary Committees of the National Associate of Insurance Commissioners (the “NAIC”) unanimously voted to implement Principles-Based Reserving (“PBR”) after concluding that PBR had met the minimum threshold requirement that at least 42 states, representing 75% of total life insurance premiums written in the United States, had adopted legislation substantially similar to the NAIC’s Model Standard Valuation Law (the “SVL”). In accordance with the recommendation of the PBR Implementation (EX) Task Force, the NAIC’s Standard Valuation Manual, which sets forth the PBR methodology, was made operative as of January 1, 2017, thereby allowing life insurers domiciled in any state that has adopted the SVL to begin using PBR for new life insurance business written on or after January 1, 2017. In order to ease the conversion to PBR, the NAIC has provided for a three-year transition period during which life insurers may, but are not required to, implement PBR. After January 1, 2020, PBR will be mandatory. While we are aware of some insurance companies that have chosen to implement PBR, the wider trend seems to be to delay adoption of PBR until the end of the three-year transition period.

With the adoption of the TCJA and the consequent reduction in value of future life reserves, the trend observed in 2017 may have an effect on the PBR adoption rate by the industry.

b. Adoption of Reserve Financing Model Regulation

In December, 2016, the NAIC adopted the Term and Universal Life Insurance Reserve Financing Model Regulation (the “A/XXX Model Regulation”), which becomes effective in each state once adopted by such state’s insurance regulator. Prior to the adoption of the A/XXX Model Regulation, the interim regulations set forth in 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") apply to life insurers using affiliated captive reinsurers (each, a “Captive”), particularly for Regulation XXX and AXXX transactions. In order to ensure consistency with the A/XXX Model Regulation, the NAIC adopted an updated version of AG 48, effective as of January 1, 2017. Once effective in a particular state, the A/XXX Model Regulation will replace AG 48. As of this writing, a handful of states have adopted the A/XXX Model Regulation, including California, Iowa, Virginia and Wyoming.

The A/XXX Model Regulation and AG 48 apply to transactions in which a ceding company cedes policies that meet the definition of “Covered Policies” to a Captive. “Covered Policies” include term and universal life insurance policies, other than “Grandfathered Policies,” where “Grandfathered Policies” are defined as Covered Policies that were (i) issued prior to January 1, 2015, and (ii) ceded, as of December 31, 2014, as part of a reinsurance treaty that would not have otherwise been exempt from AG 48, had it been in effect at the time of the cession. While the A/XXX Model Regulation and AG 48 do not directly mention refinancing transactions, we note that a number of ceding companies have actively managed refinancing transactions to ensure that the policies therein continue to meet the definition of Grandfathered Policies, while still enhancing the structure and risk-sharing arrangement.

If a transaction cedes Covered Policies to a Captive that is not otherwise exempt from AG 48 or the A/XXX Model Regulation, as applicable, then reserves up to the level set forth in Standard Valuation Manual VM-20 Requirements for PBR for Life Products
In recent years, the ceding insurer has borne the risk of a shortfall and has reduced to the amount of Primary Security actually held (i.e., none of Other Security), meaning any asset acceptable to the insurance commissioner of the ceding company’s domiciliary state.

2. Regulation XXX/Regulation AXXX Transactions

The adoption of AG 48 in the fourth quarter of 2014 and the completion of the first few AG 48 compliant transactions in 2015 provided life insurance companies with some clarity as to how transactions within the reserve financing marketplace can be accomplished. During the years since, a number of Regulation XXX/Regulation AXXX transactions were completed, all of which tended to include a few key characteristics.

From our understanding, the majority of the deals that were completed in 2017 involved risk takers financing or refinancing only the excess reserves above the VM-20 level with Other Security, while the applicable insurance company self-funded the excess reserves up to the VM-20 level with Primary Security. A number of factors have contributed to the insurers’ decisions to self-fund excess reserves below the VM-20 level, including the expense and complexity of obtaining third-party funding in the form of Primary Security in a captive transaction. As of the time of this writing, we are aware of only one transaction completed where the reserves in excess of the economic reserves but less than the VM-20 level have been funded by a third party.

Additionally, the bulk of the transactions that we have seen completed in 2017 financed or refinanced blocks of term policies, as opposed to universal life policies, largely due to the limited amount of excess reserves above the VM-20 level as well as the shortage of entities available to fund the reserves in excess of the economic reserves but less than the VM-20 level. In addition to the types of policies being financed, we also note that most transactions have a 20-year term and remain non-recourse to the ceding company and/or its affiliates.

We have also found that in the post-AG 48 market, Regulation XXX/Regulation AXXX transactions must address possible shortfalls in Primary Security. The penalty for failing to fully collateralize Primary Security is that the ceding company’s credit for reinsurance will be reduced to the amount of Primary Security actually held (i.e., none of the Other Security actually held will count for the ceding company’s credit for reinsurance). This serious consequence of a shortfall in Primary Security, implemented in the revised AG 48 following the adoption of the AXXX Model Regulation, has amplified the need for these types of transactions to provide solutions in the event of such a shortfall. In the majority of the transactions we have seen completed in recent years, the ceding insurer has borne the risk of a shortfall and the resulting loss of credit for reinsurance.

3. Litigation

Life insurance captive reinsurance companies have faced scrutiny over the last several years, as increasingly more attention has been drawn to the fact that captives are not subject to the same financial disclosures as traditional insurers and reinsurers. Critics have been calling for the NAIC and state insurance regulators to create more transparency with respect to the use of reinsurance captives in the context of Regulation XXX/Regulation AXXX transactions. Lawsuits against various life and annuity companies and reinsurers have been brought citing violations of the Racketeer Influenced and Corrupt Organization Act in the context of captive reinsurance transactions. Additionally, a handful of policyholder class action lawsuits have been brought under New York law alleging claims of misrepresentation of the financial condition of a life insurer or the legal reserve system under which it operates in the context of captive reinsurance transactions. A series of cases brought against AXA Equitable Life Insurance Company and Metropolitan Life Insurance Company were dismissed by the Southern District Court of New York in 2015 for lack of standing. And, although plaintiffs filed appeals with the U.S. Court of Appeals for the Second Circuit (the “Second Circuit Court”), the Second Circuit Court affirmed the district court rulings in 2017 and shut down the class actions.

Controversy surrounding captive reinsurance practices has recently extended to Iowa where a lawsuit was filed by Joseph Belth against the Iowa Insurance Division and Nick Gerhart, the former Iowa Insurance Commissioner. Belth’s complaint sought access to financial records of Iowa insurance companies and their captive subsidiaries that were characterized as confidential and withheld under Iowa public records laws at the Iowa Insurance Commissioner’s discretion. Belth argued that the Iowa laws, as interpreted by the Iowa Insurance Commissioner, provide “insufficient transparency” of the financial strength of life insurers, “thereby adversely affecting the interest of shareholders, policyholders, and taxpayers.” The Iowa judge, however, sided with state regulators in 2017, asserting that the documentation requested by Belth is part of insurers’ plan of operations and exempt from disclosure under Iowa law which requires confidential treatment for such plans of operations and related records.

As calls for increased transparency for captive reinsurance companies continue, regulators will remain pressured to introduce additional financial and other disclosures for such companies. Any new disclosure requirements and practices will need to be considered in light of the use of such captive reinsurance companies as alternative risk transfer vehicles which help life insurers to manage capital efficiently, reduce costs and increase capacity.

B. P&C MARKET

The extensive use of alternative risk transfer ("ART") products in the P&C market and the response of the ART market to the catastrophe events of 2017 once again demonstrated ART’s importance as an alternative to traditional capital models. The numbers clearly evidence this, as alternative reinsurance capital, in the form of catastrophe bonds, reinsurance sidecars and other insurance-linked securities ("ILS"), industry loss warranties ("ILWs") and collateralized reinsurance, continued to grow and as of the end of 2017, reached...
approximately US$82 billion, representing approximately 19% of the estimated US$427 billion total capital dedicated to global property catastrophe reinsurance. The following provides an overview of the global P&C ART market’s highlights and trends of 2017 and outlook for 2018.

1. Catastrophe Bonds

2017 was a record year for catastrophe bond issuance. There were approximately US$11 billion of new issuances, resulting in approximately US$27 billion in outstanding catastrophe bonds as 2017 came to a close. This record volume was driven by a record first-half issuance of approximately US$8.4 billion, which more than offset the lightest second-half issuance volume since 2009 that likely resulted from the ILS industry dealing with the fallout of the recent spate of major natural catastrophe events.

Notable among the catastrophe bonds were several unique issuances by the International Bank for Reconstruction and Development (“World Bank”). In July 2017, the World Bank issued US$320 million of notes to fund its pandemic emergency financing facility, which provides funding to countries facing potential pandemics to help international responders stem an outbreak before reaching pandemic proportions. In August 2017, the World Bank issued another bond to provide coverage to Mexico covering earthquake risks and named storms, and in February 2018, the World Bank issued another US$1.36 billion of catastrophe bonds covering earthquake risks for the benefit of Chile, Colombia, Mexico and Peru.

Additionally, 2017 saw First Mutual Transportation Assurance Co., the captive insurer for the New York Metropolitan Transportation Authority, reenter the market with a US$125 million bond offering covering New York storm surge and earthquake. In July 2017, AmTrust Financial Services sponsored a bond that was notable for, among other things, providing workers’ compensation coverage arising from earthquake impacts in the United States and Canada.

In November 2017, USAA returned to the catastrophe bond market for the thirtieth time, obtaining coverage for U.S. tropical cyclone, earthquake, severe thunderstorm, winter storm, wildfire, volcanic eruption, meteorite impact and “other perils.” This bond demonstrated the resilience of the catastrophe bond market, as pricing was not far off from pricing a year prior, despite the ongoing uncertainty stemming from the recent string of major natural catastrophic events.

2. ILS Market Response to 2017 Catastrophe Losses

Global insured catastrophe losses in 2017 (including losses from Hurricanes Harvey, Irma and Maria, the Mexico earthquakes and the California wildfires) totaled over US$130 billion, and market sources estimate that alternative capital absorbed as much as 15-25% of such losses. The ILS market demonstrated resilience in the face of the events of 2017, with ILS investors paying claims in a timely manner and replenishing capital at the January 1, 2018 renewals.

The impact of the 2017 events and the abundance of available reinsurance capital resulted in more modest rate increases at January 1, 2018 than many expected (in contrast to the large rate increases historically experienced after major catastrophe events). As many of the reinsurance programs exposed to the 2017 hurricane events are set to renew mid-year 2018, the full impact of the 2017 events remains to be seen.

In addition to providing protection to primary insurers, the ILS market helped to soften the blow of the 2017 events on traditional reinsurers by providing retrocessional protection. Market sources estimate that a significant portion of the 2017 catastrophe losses borne by the ILS market resulted from aggregate retrocessional arrangements.

3. Sidecars

A number of existing sidecar vehicles returned to the market in 2017 with expanded issuances relative to 2016, including Versutus (sponsored by Brit), K-Cession (sponsored by Hannover Re), Eden Re II (sponsored by Munich Re) and Sector Re (sponsored by Swiss Re). In addition, a number of new and existing sidecar vehicles came to the market in late 2017 and early 2018 in anticipation of 2018 reinsurance renewals, including Eden Re II (sponsored by Munich Re), Tholas Re (sponsored by Chaucer plc), Leo Re (funded by PGGM), Blue Lotus Re (sponsored by Sompo International), K-Cession (sponsored by Hannover Re), Viribus Re (sponsored by Amlin), Harambee Re (sponsored by Argo) and Mt. Logan Re (sponsored by Everest Re). We expect the sidecar market to continue to grow in 2018.

4. Reinsurance Purchased for National Flood Insurance Program

The National Flood Insurance Program (“NFIP”) was established in 1968 to provide flood insurance protection to U.S. property owners in areas at high risk for flooding. In many areas, the premiums charged by the NFIP are much lower than the actuarially sound rates that a private insurer would charge. Without sufficient premium revenue and accumulated surplus to pay claims, the NFIP has needed to borrow funds from the U.S. Department of the Treasury (the “Treasury Department”). Following the 2017 hurricane events, the NFIP reached its maximum borrowing capacity, causing Congress to cancel US$16 billion of the NFIP’s debt in order to allow the NFIP to pay claims related to such events. The NFIP currently owes over US$20 billion to the Treasury Department.

In January 2017, the Federal Emergency Management Agency (“FEMA”), the agency responsible for administering the NFIP, purchased US$1.042 billion of single-year reinsurance protection from a panel of 25 reinsurers. FEMA recovered the entire US$1.042 billion from its reinsurers as a result of Hurricane Harvey losses. In January 2018, FEMA returned to the reinsurance market, securing US$1.46 billion of single-year reinsurance protection from a panel of 28 reinsurers, covering 18.6% of losses from a single flood event on a US$2 billion excess of US$4 billion layer and 54.3% of losses from a single flood event on a US$2 billion excess of US$6 billion layer. FEMA is expected to continue to grow the NFIP’s reinsurance

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program in the future and potentially purchase multi-year coverage, creating potential opportunities for traditional reinsurers and the ILS market. In addition, the potential for private insurers to increase their participation in the flood insurance market could create additional opportunities for traditional (re)insurers and the ILS market. (See Section IV.A.4 below for further discussion.)

5. Global ILS Initiatives

Although Bermuda currently remains the hub of ILS activity, other jurisdictions are taking steps to attract ILS market opportunities. As further discussed herein, in December 2017, regulations creating a framework for the establishment of an ILS market in the UK took effect. In January 2018, Neon Underwriting launched the first ILS vehicle under the new regulatory regime, NCM Re (UK PCC), which entered into a US$72 million collateralized reinsurance transaction. In November 2017, the Monetary Authority of Singapore (“MAS”) announced the launch of an ILS grant program to encourage insurers and reinsurers to issue catastrophe bonds in Singapore. Under the grant program, effective as of January 2018, the MAS will fund 100% of the upfront costs incurred in connection with the issuance of catastrophe bonds in Singapore, subject to certain requirements being satisfied (e.g., a certain percentage of the service providers involved in the transaction must be Singapore-based).

6. M&A Activity

As noted herein, insurers and private equity funds exhibited a continued interest in Bermuda-based P&C reinsurers in 2017 and early 2018, as a soft market and increased available capital from the ILS market have made valuations more attractive to potential acquirers. In January 2018, AIG announced its agreement to purchase Validus for US$5.6 billion in cash (a premium of about 45% over the target’s closing share price at the end of the preceding week). AIG will look to benefit from Validus’s US$3.2 billion asset management arm, AlphaCat, specializing in ILS. Apollo Global Management LLC agreed to acquire a majority stake in Catalina Holdings (Bermuda) Ltd. in a deal expected to close in the first quarter of 2018, with RenaissanceRe Ventures taking a minority stake.

7. Outlook Ahead

As in 2017, we expect that ART mechanisms in the P&C market will continue to become more prevalent in the year ahead, and the insurance asset class, as a whole, will continue to attract new participants and new capital, particularly following the ILS market’s response to the 2017 events. We expect that traditional reinsurers will continue to explore new ways to use third-party capital to their benefit. In addition, we expect that the ILS market will continue to expand the lines of business and perils covered. In particular, emerging insurance needs for flood and cyber risks are potential growth opportunities for insurers and reinsurers who have the expertise to underwrite these risks. We expect another strong year for catastrophe bond issuance. Despite the recent spate of catastrophe events, investor demand remains very strong, as highlighted by the February 2018 US$1.36 billion World Bank issuance. We also expect sponsors to continue to bring new risks to the market as investors become increasingly sophisticated and able to assess these risks. 2018 may also see Lloyd’s of London sponsor new ILS issuances as it is reportedly looking to access the ILS market to enhance its balance sheet and capacity.

Innovations in insurtech are likely to continue to impact the way that companies underwrite and cede risk and the way that reinsurers and ILS market participants evaluate, assume and manage risk and could potentially disrupt the (re)insurance and ILS markets.

C. UK’s ILS Initiative

In 2015, it was announced that the UK would be looking to establish a corporate, tax and regulatory framework that would allow the UK access to the growing ILS market. As a key player in the global commercial and specialty insurance and reinsurance sectors, the UK government believes that London could make a significant contribution to the ILS market and become a leader in alternative risk transfer, if a competitive and robust regulatory and tax framework could be established.

Following this announcement, the UK government published two consultations on the matter, which focused on proposals for the corporate structure, taxation, authorization and supervision of ILS vehicles in the UK and included draft regulations under which the ILS regime is intended to operate. In addition, the Prudential Regulation Authority (“PRA”) and the Financial Conduct Authority (“FCA”) separately issued a joint consultation paper setting out their proposed approach and expectations in relation to the authorization and supervision of ILS vehicles.

The UK’s ILS regime has now come into force. The Risk Transformation Regulations 2017 (the “Regulations”), which set out the corporate and regulatory legislative structure for the UK’s ILS regime, came into force on December 8, 2017, and the Risk Transformation (Tax) Regulations 2017 (the “Tax Regulations”), which set out the tax legislative structure, came into force on December 15, 2017.

In addition, the PRA published the final version of an amended PRA Rulebook, including new rules to incorporate the ILS regime and the FCA published its final statement on authorizing and supervising special purpose vehicles for ILS.

Both the Regulations and the Tax Regulations have resulted in fundamental changes to the UK’s corporate, tax and regulatory regimes, as outlined below.

1. Corporate Structure

   a. PCC Regime

The Regulations establish a new Insurance Special Purpose Vehicle (“ISPV”), which can either operate a single risk transfer contract or can take on multiple contracts for risk transfer (otherwise known as a multi-arrangement ISPV). Following suggestions in its initial consultation that the UK’s ILS framework should be built around the protected cell company (“PCC”) structure, the Regulations have amended company and insolvency laws to allow for the establishment of PCCs as a form of ISPV in the UK.

Under the Regulations, a PCC is a private company limited by shares and not a public limited company, as it is considered inappropriate
for ISPVs to make public offerings for investment. PCCs comprise of a core entity and any number of cells that are needed to conduct the ILS deals it takes on. The cells do not have any legal personality. It is the core entity which performs the administrative functions of the PCC and enters into and manages transactions on behalf of the cells.

The purpose of the PCC structure is to allow for efficient management of multiple ILS deals under one vehicle, while keeping the assets and liabilities associated with one cell completely segregated from the other cells in the PCC. Under the PCC structure, there is no longer any need for the incorporation of multiple vehicles, and cells can be added to and dissolved from the structure with a simple board resolution. The PCC will be able to issue debt and equity securities on behalf of the cells and, as is standard practice with these structures, investors will have no voting rights or means of influencing the management of the PCC.

As the PCC structure is familiar to ILS cedants, investors and arrangers, allowing for the incorporation of this type of vehicle in the UK is seen as an essential component of the new regime.

b. Registering ISPVs as PCCs

As set out in the Companies Act 2006, most companies in the UK are required to directly apply to Companies House for registration and incorporation. However, to allow for a more streamlined process, Chapter 2 of the Regulations grants the FCA responsibility for the registration, incorporation and dissolution of PCCs and individual cells.

The FCA will consult with the PRA in relation to this process. It will also provide limited details of a PCC to Companies House, for the Companies House register, while keeping the full details on its own register.

2. Tax Changes

In order for the UK to be a viable alternative to existing jurisdictions which cater ILS vehicles (most notably Bermuda), it was considered necessary for the new ISPV to benefit from a bespoke UK tax regime. To ensure that the ISPV is internationally competitive from a tax perspective, the Tax Regulations provide that: (a) the insurance risk transformation functions of the ISPV are exempt from UK corporation tax; and (b) an exemption from UK withholding tax on payments (both debt and equity) from the ISPV to non-UK resident investors. The net effect of these provisions is to ensure that the ISPV remains tax neutral.

The application of the bespoke UK tax regime will, however, be subject to certain conditions. For example, the tax advantages will not be available where the vehicle is used as part of a tax avoidance scheme or where the risk is effectively retained through a cedant’s investment in the vehicle.

3. Regulatory Changes

If an applicant wishes to operate as a PCC in the UK, it will need to apply to the PRA for permission to carry out the new regulated activity of insurance risk transformation, which is set out in Section 13A of the Financial Services and Markets Act 2000 (Regulated Activities) Order 2001. ISPVs are dual regulated by the PRA and FCA. A streamlined authorization approach has been established, in recognition of the fact that ILS vehicles exist for the very particular purpose of risk transfer. That being said, applicants will still have to go through the full application process, which includes pre-application discussions, drafting and submitting the newly established PCC application form, showing that the ISPV is fully funded and submitting application forms for certain senior individuals, in compliance with the Senior Insurance Managers Regime (“SIMR”).

The PRA and FCA anticipate that an approval decision will be reached for straightforward PCC applications within six to eight weeks of the application being submitted, provided that such applications are supported by good documentation and the applicants have actively engaged in the pre-application discussions. However, it is expected that PCC applications will vary in complexity, and the PRA and FCA have stated that they will allow up to six months for consideration of an initial PCC application in more complex cases.

The authorization process for establishing new cells is fairly simple as applicants will only need to provide a further notification to the PRA of their desire to establish a new cell. New cells should not be established until an applicant has either received confirmation from the PRA that it does not object to the establishment of the cell, or 10 working days since the submission date has elapsed and the applicant has not received notification that the PRA or FCA objects to the application.

In addition, and as mentioned above, ISPVs will be subject to the SIMR, and where applicable, the FCA’s controlled functions regime, and should therefore be mindful of their obligations in relation to this.

4. UK ILS Outlook

The new ILS regime is a welcome step in the right direction for the UK. With continued uncertainty around Brexit, it is key that this regime creates the necessary incentives to attract new investors and provide a strong regulatory framework to allow the UK to be a key player in the ILS market.

While the targeted authorization timeline of six to eight weeks for PCCs is accelerated in comparison to the authorization timelines for general insurance undertakings in the UK, it is still slower than other jurisdictions that offer similar special purpose vehicle structures (such as Bermuda where new special purpose entities can be set up in one to two weeks). The speed of approval was a concern shared by many respondents during the consultation process and it is hoped that this will not hinder uptake of the UK as an ILS jurisdiction.

That being said, in the short time that the Regulations and Tax Regulations have been in force, the UK has already approved its first ILS structure for Neon, and it is anticipated that others will follow suit.

D. TRADITIONAL CAPITAL MARKETS

In 2017, the pace of capital markets transactions remained fairly constant for traditional debt offerings while beginning to increase in the case of funding agreement-backed note issuances. We are not aware of any initial public offerings closing in the U.S. market in 2017.
Insurance companies continue to raise funds via traditional debt offerings, typically in the form of senior note offerings. Great-West sold US$700 million 4.15% senior notes with a 30-year term. Sammons issued US$500 million 4.45% bonds with a 10-year term. American Financial Group sold a total of US$365 million of senior notes, issued in two tranches. The first tranche included nine-year notes at a rate of 3.5% and the second tranche included 30-year notes at a rate of 4.5%. In July of 2017, Voya sold US$400 million senior notes due in 2024 at a rate of 3.125%. The notes were guaranteed by Voya Holdings and the proceeds were used to redeem a portion of Voya’s senior notes due in 2018. In May of 2017, Kemper sold US$200 million senior notes due in 2025 with a rate of 4.35%. In April of 2017, Progressive sold US$850 million 30-year senior notes at a rate of 4.25%. The proceeds were used to redeem certain of its existing subordinated debentures.

Other traditional debt offerings in 2017 include American Equity Investment Life Holding Company’s offering of US$500 million 5% senior unsecured notes due in 2027; Radian Group’s offering of US$450 million 4.5% senior unsecured notes due in 2024; Mercury General Corporation’s offering of US$375 million 4.4% senior notes due in 2027; United Insurance Holdings Corp.’s offering of US$150 million 6.25% senior notes due in 2027; Heritage Insurance Holdings, Inc.’s offering of US$125 million 5.875% convertible senior notes due 2037; and Kingstone Companies, Inc.’s, a property and casualty insurance holding company, offering of US$30 million 5.5% senior unsecured notes due in 2022.

Funding agreement-backed note programs continue to be used by life insurance companies, allowing them to fund a portion of their institutional spread business through private placement securitization vehicles, such as global medium-term note (“GMTN”) programs. GMTN programs provide a life insurance company with flexibility in that it can issue GMTNs both to investors outside the United States pursuant to Regulation S and to “qualified institutional buyers” within the United States pursuant to Rule 144A. 2017 saw the usual participants in the funding agreement-backed notes market (which include MetLife, New York Life, Massachusetts Mutual and Principal Life) as well as the life insurance companies that entered (or re-entered) the market in the past few years (which include AIG, Reliance Standard Life Insurance Company, Protective Life, Athene and Guardian Life).

The U.S. Securities and Exchange Commission (the “SEC”) Staff (the “Staff”) have provided comment letters in 2017 with respect to insurance company transactions focusing on the following areas:

- **Short Duration Insurance Contracts.** The Staff has requested clarification, concerning how an insurer has complied with ASU 2015-09, which requires enhanced disclosure for short-duration insurance contracts. Comments from the Staff have largely focused on the aggregation of claim data as set forth in claims development tables, on disclosures regarding the basis for reporting commutations and on how foreign operations and reinsurance arrangements are presented.

- **Non-GAAP Measures.** The Staff has continued to closely scrutinize non-GAAP measures and provide additional guidance regarding how such measures can be used. The Staff has been particularly concerned with the prominence of non-GAAP measures and has focused its comments on increased disclosure surrounding the purpose and use of such measures, reconciliation requirements and clear labeling.

- **Contacts with State Sponsors of Terrorism.** The Staff has required specific disclosure surrounding the nature, extent and materiality of contacts with Syria, Sudan and Iran, as such countries are designated as state sponsors of terrorism by the U.S. Department of State. Such disclosure must be quantitative and qualitative in nature, in other words, insurers must provide information regarding both its revenues, assets and liabilities associated with these countries as well as any other non-numerical factors that may have impacted their activities.

- **Cybersecurity.** The Staff has encouraged more robust disclosure surrounding cybersecurity to ensure that any material cybersecurity risks or cyber incidents are properly disclosed.

- **Management’s Discussion and Analysis (“MD&A”).** The Staff has focused on the discussion of critical accounting estimates in MD&A. Instead of including portions of the significant accounting policies financial statement footnote verbatim in MD&A, the Staff has commented that it would like to see a more fulsome analysis of accounting estimates, including what assumptions were used in developing such estimates and what effect changes to those assumptions could have on the financial statements.

### III. The Global Longevity Market

The two principal sources of longevity risk are defined benefit pension schemes and books of annuity business written by life insurers. There has been a significant increase in the level of transaction activity in relation to the latter, with many European-based life insurance groups looking to hedge longevity exposure in light of the additional regulatory capital required under Solvency II in respect of annuity business. This, coupled with the continuing demand from defined benefit pension schemes, has led to the development of an active secondary market for longevity risk in which reinsurers have been the principal participants.

With increases in life expectancy in recent decades, pension schemes have increasingly been looking for methods to hedge against the risk that their members live longer than is currently predicted. The UK is the most mature market for the “de-risking” of pension schemes. This has been driven by the large number of defined benefit pension schemes in the UK and improvements in life expectancy and poor investment returns that have left many schemes in deficit. This in turn has adversely affected the balance sheets of corporate sponsors who are liable to make good such deficits. The vast majority of transactions executed to date have taken the form of traditional bulk annuity deals either in the form of pension buy-outs or involving the issue of a buy-in policy. However, longevity swaps have also now become a well-established alternative option for hedging longevity exposure.
A. TRANSACTION STRUCTURES
To put into context our review of recent developments and transactions in the longevity market, we first briefly recap below the principal longevity risk transfer methods.

1. Buy-Outs
A pension buy-out involves an insurer taking over the liability to pay all or some of the member benefits from the trustees of the relevant pension scheme. This is achieved by the insurer issuing individual annuity policies to the relevant scheme members in return for a payment of premium by the trustees, usually by way of a transfer of assets from the pension scheme to the insurer. In the case of a buy-out, there is a direct insurance contract between the insurer and the individual scheme member; and in the event of a full buy-out, where individual policies are issued to all of the members of the pension scheme, the trustees can proceed to wind-up the scheme, with all future administration being performed by the insurer. The buy-out option is accordingly the ultimate form of pension scheme de-risking.

2. Buy-Ins
Pension buy-in solutions were developed as a de-risking option for pension schemes that were unable to afford the often prohibitive costs of a full buy-out. Under a pension buy-in, there is no direct contractual link between the insurer and the individual scheme members. Instead, the pension scheme trustees hold the buy-in policy in their name as an investment of the scheme, and the scheme continues to deal with the payment and administration of benefits. The trustees pay a premium (usually by transferring an equivalent amount of pension scheme cash, bonds and other assets under management) and, in return, receive an income stream from the insurer to cover some or all of the scheme’s liability to pay member benefits. In the case of some of the larger buy-in transactions, trustees will also require the insurer to post collateral or otherwise secure its obligations to make payments under the policy.

3. Longevity Swaps
In their purest form, longevity swaps are derivatives and not contracts of insurance. However, it is possible to achieve the same economic effect on an insurance basis, and there have been examples of insurers issuing policies to pension schemes structured in the same way as a longevity swap. Although it is clearly important to ensure that the contract is properly structured as a derivative or insurance policy according to whether the protection provider is a bank or insurer, in either case, the core economics are very similar. In return for the pension scheme paying a fixed monthly amount to the insurer or bank, the counterparty makes a payment to the pension scheme on a monthly basis (the floating amount) referable to the benefit payable to a defined group of pensioners.

In cases where the front-end arrangement involves a longevity swap with a bank as a counterparty, the longevity risk is in derivative form and not capable of being directly reinsured. In situations such as this, transformer vehicles (typically based off-shore) are used to convert the derivative exposure into insurance risk that can then be reinsured. Whereas buy-ins and buy-outs involve a transfer of inflation, interest rate, investment and longevity risk, longevity swaps offer a purer hedge against the risk of scheme members living longer than is actuarially predicted. In addition, the fact that there is no upfront payment of a lump-sum premium means that each of the investment, interest rate and inflation risk remain with the trustees. Accordingly, longevity swaps are typically a less expensive alternative to buy-ins and buy-outs, albeit more complex to structure and negotiate. Longevity swaps almost invariably require the two-way posting of collateral to protect against the possibility of early termination by reason of the other party’s default or insolvency. The collateral is typically based upon the present value of the covered benefits and will also include a fee element payable to the insurer or bank in the event of termination arising by virtue of trustee default.

4. Index-Based Trades
A further alternative structure involves the purchase of longevity protection by reference to an index. Given the inherent basis risk that exists within these types of transactions, there have been relatively few index-based trades to date, and these types of transactions are perhaps more likely to remain of greater interest to insurers and ILS investors than to pension schemes.

B. U.S. MARKET
Beginning with the GM and Verizon deals in 2012, the pension de-risking market in the U.S. experienced significant growth. In prior years, the market consisted primarily of one direct writer (The Prudential Insurance Company of America (“Pru”)) providing the majority of the capacity, particularly in connection with larger transactions. However, over the past couple of years, other group annuity writers have become more active in the market, in particular Massachusetts Mutual Life Insurance Company (“MassMutual”), Metropolitan Life Insurance Company (“MLIC”) and new to the market this year, Athene Annuity and Life Company (“Athene”) and American General Life Insurance Company, a subsidiary of AIG (“AGL”), among others. The increase in interest and market participants has led to a huge year for pension de-risking transactions. According to the LIMRA Secure Retirement Institute, the pension buy-out sales in the U.S. in the first three quarters of 2017 totaled over US$11.5 billion, a huge increase as compared with the same period in 2016 (with sales of approximately US$8 billion).

Some of the large pension de-risking transactions that have been consummated in 2017 include The Hartford, Sears Holding Corp. (“Sears”), MillerCoors LLC (“MillerCoors”) and Accenture Plc (“Accenture”) transactions (described below). Unlike the variety of transactions executed in the UK, transactions in the United States have generally used only the buy-out approach outlined above.

As mentioned above, The Hartford purchased a group annuity contract from Pru in order to transfer approximately US$1.6 billion of its U.S. pension plan liabilities (representing approximately 29% of Hartford’s pension obligations). The transaction will transfer pension benefits for approximately 16,000 retirees.

Sears closed two transactions in the second and third quarters of 2017. In May, Sears entered into an agreement with MLIC to annuitize US$515 million of pension liability. Pursuant to the agreement, MLIC will pay future pension benefit payments to approximately 51,000 Sears retirees. A few months later, Sears purchased a second group
annuity contract from MLIC to transfer approximately US$512 million of pension liability, covering benefits to approximately 20,000 additional Sears retirees.

Similarly, MillerCoors entered into an agreement to transfer approximately US$900 million in pension obligations to Athene. Pursuant to the agreement, Athene will provide annuity benefits to over 6,000 retirees and their beneficiaries who are receiving benefits from the MillerCoors pension plan. Athene will administer the group annuity payments and begin making benefit payments to the affected individuals.

Accenture completed the termination of its U.S. pension plan by entering into agreements with AGL and MassMutual to transfer approximately US$1 billion of outstanding pension obligations and settling the remaining US$600 million through lump-sum payments to approximately 7,000 employees who elected to receive such payments. Pursuant to the purchase agreement, Accenture bought group annuity contracts from AGL and MassMutual covering approximately 9,200 active and former employees and their beneficiaries.

In addition to the pension de-risking market, we have also seen increased activity in longevity reinsurance. In certain circumstances, the reinsurance relates to underlying pension plan risk, but in others, it relates to annuity business that is not sourced from an underlying pension plan. Further, certain of these transactions are cross-border transactions pursuant to which U.S.-domiciled reinsurers are providing longevity reinsurance to foreign ceding companies, particularly in the UK.

As in prior years, we expect these markets to continue to develop as the number of market participants grows and pension plan sponsors become more aware of the benefits of these transactions.

C. UK/EUROPEAN MARKET

There was a significant increase in activity in the UK’s traditional bulk annuity market (pension buy-ins and buy-outs) in 2017, with overall deal volumes estimated to be in excess of £10 billion. Additionally, after a relatively quiet 2016, the market for longevity only risk transfer transactions between UK pension schemes and insurers was also more active in 2017, with the largest being the £3.4 billion deal between the Marsh & McLennan Companies’ UK pension fund and Pru and Canada Life Re. That transaction and the £1.6 billion longevity swap in respect of the British Airways’ pension scheme (reinsured by PartnerRe and Canada Life Re) both utilized a structure involving a captive insurer providing primary protection in order to transform the risk into a form that could then be assumed by the international reinsurance market.

Market commentators predict a significant increase in the volume of activity in both the traditional bulk annuity and longevity swap market in the UK in 2018. Factors fueling this market optimism include a healthy capacity within the UK life market for buy-in and buy-out transactions, strong availability of reinsurance capacity for longevity risk and a benign pricing environment (from the perspective of the protection buyer) driven at least in part by a marked reduction in the level of longevity improvements in the UK.

A trend that first emerged in 2015 in anticipation of Solvency II coming into effect, and which has accelerated through 2016 and 2017, is the increase in the number of UK and continental European life companies buying longevity protection in the form of reinsurance. While some such transactions have been structured as longevity swaps (including for example Scottish Widows transaction with Pru covering £1.3 billion of liabilities), there was also activity through 2017 in the market for reinsuring longevity and asset risk by means of single premium reinsurance policies on a collateralized basis, often to reinsurers based outside the EU. This trend is set to continue, with there still being healthy levels of capacity within the life reinsurance market for longevity risk. This demand has been driven by a number of factors, but perhaps the most significant for life reinsurers with catastrophe books is that longevity risk acts as a natural hedge against mortality exposure and can create diversification benefits for regulatory capital purposes.

Against this market backdrop, the PRA has indicated that it continues carefully to monitor the trend of UK insurers to reinsure longevity risk exposure. Following its supervisory statement in November 2016 entitled “Solvency II: Longevity risk transfers,” the PRA has continued to emphasize the importance of firms managing counterparty default risk. The PRA has stated that it expects firms to manage and mitigate reinsurance counterparty default risk under Solvency II, and that this includes a requirement on firms to have a risk management system covering concentration risk management. The PRA has indicated that it may not be sufficient to refer to the solvency capital requirement components covering counterparty default risk and risk concentration and that additional measures besides capital may be required.

The PRA has also observed that it would be concerned if firms became active in this market for reasons other than seeking genuine risk transfer, and confirmed that it expects to be notified of longevity risk transfer arrangements and a firm’s proposed approach to risk management well in advance of completing such a transaction. The PRA made it clear that this notification expectation applies whether a firm is buying or selling longevity protection and is intended to facilitate the PRA’s understanding of the potential build-up of risk concentrations as a result of these transactions. However, the PRA has also acknowledged more recently that it would be happy to work with the industry to determine whether some of the information currently provided by insurers in their notifications could be omitted so as to reduce any undue burden. The PRA has indicated that it may review the current notification requirements after it has completed a series of “deep dives” into firms’ counterparty risk management.

Whilst there have been some concerns expressed in the market that the PRA’s increased scrutiny of longevity risk transfer transactions may lead to a reduction in longevity risk transfer from UK insurers, it does not seem to us that this should necessarily follow. The PRA’s observations in relation to the need for there to be effective risk transfer, and for ceding companies appropriately to manage counterparty default exposure, do not represent new requirements, and have been carefully considered in any event by ceding companies and their reinsurers when structuring transactions to ensure appropriate credit for reinsurance under Solvency II. In particular, longevity reinsurance risk transfer arrangements (whether in swap form or otherwise) are typically collateralized and the quality...
and nature of the collateral is carefully structured in order to ensure that it effectively mitigates counterparty default risk within the requirements of Solvency II.

IV. Global Regulatory and Litigation Developments

In 2017, the global insurance industry continued to examine difficult questions regarding the interpretation and intersection of U.S. federal, state and non-U.S. insurance regulation. In the United States, during the first year of Donald Trump’s presidency, changes to the implementation of federal laws and regulations adopted under the prior administration have reaffirmed the U.S. system of state-based insurance regulation. Throughout the year, states continued efforts to develop and enforce prudential and market conduct regulations. In the UK, preparations for the UK’s exit from the EU and uncertainty surrounding this, have been the primary focus for many (re)insurers. In addition, firms have also had to prepare for new legislation around the sale and distribution of insurance products and the General Data Protection Regulation (“GDPR”), which are due to be implemented this year. There have also been further developments in competition law enforcement across the EU and in the SIMR, which is set to be replaced by the Senior Managers and Certification Regime (“SM&CR”), the regime that currently applies to banks.

A. U.S. FEDERAL ACTIVITY

1. Financial Stability Oversight Council

Although the process has not been eliminated outright, over the course of Donald Trump’s first year as President of the United States, his administration has signaled that it is unlikely that his Financial Stability Oversight Council (“FSOC”) will name any new non-bank systemically important financial institutions (“SIFIs”). An initial signal came in April 2017, when President Trump issued an executive memorandum (the “Executive Memorandum”) that imposed a moratorium on non-emergency SIFI determinations and designations pending completion of a report from the Secretary of the Treasury Department regarding FSOC processes. The requested report, which the Treasury Department published on November 17, 2017, recommends significant changes to FSOC processes for making SIFI determinations and designations. Specific recommendations include, among others, (a) revising FSOC’s guidance to require FSOC to conduct a cost-benefit analysis as part of the designation analysis and only designating a company “if the expected benefits to financial stability outweigh the costs of designation,” and (b) providing a clear “off-ramp” for designated non-bank SIFIs. Implementation of these recommendations will make it easier for future-designated SIFIs to identify changes that may be required to shed such designations or, alternatively, challenge such designations in court (because a cost-benefit analysis is inherently imprecise).

In fact, in March 2016, MetLife, Inc. (“MetLife”), the only non-bank SIFI to challenge its designation, won its suit against FSOC before the U.S. District Court for the District of Columbia. The court’s ruling became final after MetLife and FSOC, in January 2018, filed a joint motion to dismiss FSOC’s appeal (which appeal was filed under the Obama administration and which was stayed throughout 2017 per the Executive Memorandum, pending completion of the report from the Treasury Department). Of the four firms that were assigned non-bank SIFI designations since 2013, Prudential Financial, Inc. is the only designation that remains in effect. The SIFI designation assigned to American International Group, Inc. was rescinded in September 2017, and the SIFI designation assigned to General Electric Capital Corporation was rescinded in June 2016.

FSOC was established under the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (the “Dodd-Frank Act”) to provide recommendations to the Board of Governors of the Federal Reserve System (the “Federal Reserve”) concerning risks to U.S. financial stability caused by the activities of large bank holding companies and non-bank financial companies. A company designated as a SIFI becomes subject to supervision by the Federal Reserve and to enhanced prudential standards approved by the Federal Reserve.

2. U.S.-EU Covered Agreement

The “Bilateral Agreement Between the European Union and the United States of America on Prudential Measures Regarding Insurance and Reinsurance” (the “Covered Agreement”) was signed by the United States and the EU in September 2017. Although the fate of the Covered Agreement, which was negotiated under the Obama administration and submitted to Congress one week before Donald Trump’s Presidential inauguration, initially was uncertain, the Covered Agreement became provisionally effective on November 7, 2017, following completion of the EU’s procedural requirements, but must be approved by the European Parliament before it is treated as “fully” effective.

The Covered Agreement was negotiated pursuant to Title V of the Dodd-Frank Act, which authorizes the Federal Insurance Office (the “FIO”) to assist the Secretary of the Treasury Department (the “Treasury Secretary”) in negotiating covered agreements. A “covered agreement” is an agreement between the United States and one or more foreign governments, authorities or regulatory entities regarding prudential measures with respect to insurance or reinsurance.

The Covered Agreement primarily addresses two areas of prudential insurance supervision: group supervision and reinsurance collateral requirements. The Covered Agreement also encourages insurance supervisors in the United States and the EU to share information, and a form of memorandum of understanding regarding information exchange, which insurance supervisors are encouraged to adopt, is included as an annex to the Covered Agreement.

With respect to group supervision, the Covered Agreement prohibits EU insurance supervisory authorities from applying the solvency and capital requirements under the European market's Solvency II to the worldwide operations of U.S. insurers. U.S. insurance groups that operate in an EU member country can only be supervised at the worldwide group level by U.S. insurance supervisors. Likewise, group supervision of insurers based in EU member countries is solely the responsibility of the insurance supervisory authority in the EU member country.

With respect to reinsurance collateral requirements, in a major departure from current U.S. insurance law, subject to certain conditions, the Covered Agreement prohibits a U.S. territory (i.e.,
state) from imposing any reinsurance collateral requirements upon
an EU assuming reinsurer that would result in the EU reinsurer
receiving less favorable treatment than assuming reinsurers domiciled
in the state. In turn, an EU member country may not impose any
local presence or other similar restrictions which would result in a
U.S. reinsurer receiving less favorable treatment than EU assuming
reinsurers that are domiciled (or have their head office), licensed or
permitted to operate in the same EU member country as the ceding
insurer.

These areas of prudential insurance regulation are also of importance
to the NAIC. (See Section IV.B.2 below for discussion regarding the
impact of the Covered Agreement on NAIC initiatives.)

3. Future Role of the FIO

One year ago, the role of the FIO seemed uncertain following the
inauguration of President Trump and the departure of the FIO’s
first and only director, Michael McRaith. House Republicans called
for reform, proposing consolidating the Director of the FIO into a
new independent insurance advocate position within the Treasury
Department.

Today, while the Treasury Department continues its process to select
a new Director of the FIO, efforts remain to reform the FIO consistent
with recent recommendations made by the Treasury Department in a
report issued in October 2017. The report was issued in response to a
February 2017 executive order by President Donald Trump, which
tasked the Treasury Department with identifying laws and regulations that “promote or inhibit federal regulation of the U.S. financial
system” consistent with the core principals identified by President
Trump in the executive order. The requested report sets forth “five
pillars of focus” to guide the FIO’s mission and to “ensure consistency
with the long-established U.S. policy of state-based insurance
regulation.” This is a shift from the FIO’s report issued in December
2013, which discussed the necessity of federal involvement in the U.S.
state-based insurance regulatory system.

The “five pillars” are: (a) to promote the U.S. state-based insurance
regulatory system and advocate for the U.S. insurance sector in
international forums and negotiations and in foreign markets; (b)
to provide insurance policy expertise and advice to the federal
government, state insurance regulators and industry through
comprehensive research and analysis, consultation on emerging
issues and evaluation of federal insurance programs; (c) to provide
coordinated and collaborative leadership on insurance issues that
effect the federal government and state insurance regulators; (d)
to protect the U.S. financial system and economy by advising the
Treasury Secretary and FSOC on insurance-related matters that may
damage U.S. financial stability; and (e) to protect America’s
financial security by promoting access to insurance products and
administering the Terrorism Risk Insurance Program ("TRIP").

The report also calls for increased transparency and stakeholder
government, more regular and consistent engagement with state
insurers and stakeholders on developing issues and to
provide input when the business of insurance is implicated at
the federal level. With regard to federal agency coordination, the report

recommends “a more structured and rationalized approach” to the
FIO’s engagement with federal agencies and entities on insurance-
related issues. Particular focus is also placed on the need for the FIO
to support the U.S. state-based regulatory system in international
forums, noting that a “unified federal voice” promoting the interests
of the U.S. state-based system is necessary to strengthen the
influence of the United States internationally.

Under the Dodd-Frank Act, the FIO was established within the
Treasury Department to monitor all aspects of the insurance industry
and lines of business other than certain health insurance, long-term
care insurance and crop insurance. While the FIO does not serve in
a regulatory capacity, the FIO represents the U.S. in international
insurance forums, provides policy expertise for the federal
government, addresses foreign market access issues, assists
the Treasury Secretary in the administration of the TRIP and has
a non-voting seat on FSOC.

4. NFIP Reinsurance Program

As discussed in Section II.B.4. above, the NFIP was established in
1968 to provide flood insurance protection to U.S. property owners
in areas at high risk for flooding. In recent years, the impact of several
large floods has left the NFIP with insufficient policy premiums and
accumulated surplus to pay claims and resulted in the NFIP borrowing
funds from the Treasury Department. Through legislation enacted
in 2012, FEMA, which administers the NFIP, gained the authority to
secure reinsurance protection from private markets to help fund NFIP
claims payments. FEMA first purchased reinsurance pursuant to this
authority in September 2016 and since that time, the program has
continued to grow. Under the 2017 reinsurance agreement, of the
US$7.6 billion of losses paid by FEMA to policyholders as a result of
Hurricane Harvey, FEMA has recovered US$1.042 billion from the
private markets. Under the 2018 reinsurance agreement, 28 private
reinsurers have agreed to indemnify FEMA for flood claims on an
occurrence basis. The agreement is structured to cover 18.6% of
losses between US$4 billion and US$6 billion, and 54.3% of losses
between US$6 billion and US$8 billion. FEMA paid a total premium
of US$235 million for the coverage.

5. Department of Labor – Fiduciary
Rule Faces Uncertain Future

On April 6, 2016, the U.S. Department of Labor (“DOL”) issued an
amendment to DOL regulations defining the term “fiduciary” (the
“Fiduciary Rule”) that would significantly expand who is considered
a “fiduciary” for purposes of the Employee Retirement Income
Security Act of 1974, as amended (“ERISA”), by including individual
retirement accounts (“IRAs”) within its scope, and revised the
exemptions to the prohibited transaction provisions of the Internal
Revenue Code of 1986, as amended (the “Code”), thereby materially
affecting, among other things, the manner by which financial advisers
can recommend proprietary investments or receive certain types of
transaction-based compensation. The amendment to the definition
of fiduciary and the changes to the exemptions to the prohibited
transaction provisions of the Code are expected to fundamentally
change the way insurance companies do business and could limit the
types of investments that can be sold to certain plans and IRAs.
The DOL originally designated April 10, 2017 as the Fiduciary Rule’s applicability date in order to provide insurance companies an opportunity to review current business practices, make appropriate changes and evaluate whether certain investments should no longer be offered to certain plans and IRAs. However, on March 2, 2017, the DOL published a proposal, subject to a 15-day comment period, to extend the April 10, 2017 applicability date for 60 days. The proposal was finalized and the Fiduciary Rule went into effect on June 9, 2017. In connection with the delayed effective date, the DOL also delayed the need to fully comply with all of the requirements of the Fiduciary Rule’s new exemptions, the best interest contract exemption and the principal transactions exemption, as well as the applicability of amendments to an existing exemption related to certain insurance and annuity transactions (PTE 84-24) until January 1, 2018.

In August 2017, the DOL proposed an 18-month extension of the transition period, such that the period would end as of July 1, 2019, rather than January 1, 2018. On November 29, 2017, the DOL published a notice in the Federal Register that finalized such proposal following public comment.

During this transition period, fiduciaries are required only to satisfy the following “impartial conduct standards” for relief under the best interest contracts exemption and the principal transaction exemption: (a) provide prudent advice that is in retirement investors’ best interest; (b) charge no more than reasonable compensation and (c) avoid misleading statements.

The applicability of the amendments to PTE 84-24, which would have revoked the availability of such exemption for certain types of annuity contracts, has also been delayed for the duration of the transition period; however, the “impartial conduct standards” discussed above still apply to fiduciaries seeking relief under PTE 84-24 during the transition period.

6. Derivative Transactions
   a. Updated CFTC Recordkeeping Rules

On May 30, 2017, the Commodity Futures Trading Commission (“CFTC”) adopted a final rule, which modernizes the CFTC’s recordkeeping rules and identifies new standards which are required to be employed for electronically retained records. Under current CFTC regulations, both swap dealers and end-users are required to collect and maintain certain records relating to each swap transaction they enter into. Under the new, modernized recordkeeping rules, end-users, such as insurance companies, now have greater flexibility in terms of the manner in which they maintain the swap records they are otherwise required to maintain under the CFTC’s rules (the “Regulatory Records”). Specifically, insurance companies are required to maintain their Regulatory Records for each swap from the date of creation until five years following the termination, maturity, expiration, transfer, assignment or novation of the swap, whichever occurs first. Any such Regulatory Record exclusively created and maintained on paper only needs to be retained in original paper format and readily accessible for the first two years from creation, and thereafter may be maintained in an electronic format that is readily accessible for the remainder of the required period. Under the new rule, any records stored in an electronic format (either following conversion from paper or original electronic files) need to be maintained on a system that: (i) maintains the security, signature and data as necessary to ensure the authenticity of the information contained in the records; and (ii) ensures the availability of such records in the event of an emergency or other disruption of the insurer’s electronic record retention system. An end-user insurance company is also required to create and maintain an up-to-date inventory that identifies and describes each system that maintains information necessary for accessing or producing the electronic Regulatory Records. Additionally, the new rule requires each end-user insurer to also be responsible for establishing appropriate systems and controls that ensure the authenticity and reliability of any electronic records system that stores any such Regulatory Records.

b. Qualified Financial Contracts Limitation of Termination Rights

As part of the continued implementation of the Dodd-Frank Act, in the fall of 2017 the banking regulators adopted final rules (the “QFC Rules”), which purport to “promote U.S. financial stability by improving the resolvability and resilience” of various financial institutions. As a result of the new QFC Rules, many insurance companies will be required to amend their existing swap and derivatives trading documentation (including repurchase (repo) agreements, securities lending agreements and forward transactions) if they want to continue trading with the covered financial institutions on or after July 1, 2019. The amendments required by the QFC Rules fall into two general categories—the “opt-in” requirements and the “cross-default” requirements, each of which are addressed separately below.

i. Opt-In Requirements

The opt-in requirements mandate that each covered QFC explicitly provide that in the event the covered banking entity becomes subject to a proceeding under the Federal Deposit Insurance Act (“FDIA”) or the orderly liquidation authority under Title II of the Dodd-Frank Act (“OLA”); (x) the transfer of the QFC (and any interest and obligation in or under and any property securing it) from the covered banking entity will be effective to the same extent as the transfer would be

6 Each of the Federal Reserve, Federal Deposit Insurance Corporation (“FDIC”) and Treasury Department, Office of the Comptroller of the Currency (“OCC”) adopted separate rules, each of which are substantially similar, but apply to the various financial institutions that are regulated by each agency; The Federal Reserve final rule is titled “Restrictions on Qualified Financial Contracts of Systemically Important Foreign Banking Organizations; Revisions to the definition of Qualifying Master Netting Agreement and Related Definitions” 82 FR 42882 (September 12, 2017). The FDIC final rule is titled “Restrictions on Qualified Financial Contracts of Certain FDIC-Supervised Institutions; Revisions to the Definition of Qualifying Master Netting Agreement and Related Definitions” 82 FR 50228 (October 30, 2017). The OCC final rule is titled “Mandatory Contractual Stay Requirements for Qualified Financial Contracts 82 FR 56630 (November 29, 2017).

4 See 82 FR 24479, which amends Part 1.31 of the CFTC’s regulations.

5 Part 45.2(b) of the CFTC’s regulations provides, “All non-[Swap Dealer/ Major Swap Participant] counterparties subject to the jurisdiction of the [CFTC] shall keep full, complete, and systematic records, together with all pertinent data and memoranda, with respect to each swap in which they are a counterparty, including, without limitation, all records demonstrating that they are entitled, with respect to any swap, to elect the clearing requirement exception in CEA Section 2(h)(7).”

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effective under the FDIA or OLA if the QFC (and any interest and obligations in or under, and any property securing it) were governed by the laws of the United States or a state of the United States; and (y) default rights with respect to the QFC that may be exercised against the covered entity are permitted to be exercised to no greater extent than the default rights could be exercised under the FDIA or OLA if the QFC were governed by the laws of the United States or a state of the United States.

However, the opt-in requirements do not apply to a QFC if the QFC already explicitly provides that it is governed by the laws of the United States or a state of the United States, and each party to the QFC (other than the covered banking entity) is either (1) an individual domiciled in the United States, (2) a company incorporated in or organized under the laws of the United States or that has its principal place of business in the United States or (3) is a government branch or agency of the United States. Thus, to the extent that an insurance company is organized in, or has its principal place of business in, the United States and the relevant QFC is governed by the laws of a state in the United States, then the relevant QFC will not need to be amended to address the opt-in requirements.

ii. Cross-Default Requirements

The cross-default requirements limit the ability of end-users to exercise certain default rights under a QFC that relate to an affiliate of the covered banking entity that is the direct party to the QFC becoming subject to a receivership, insolvency, liquidation, resolution or other similar proceeding (a “Protected Action”). In other words, if a QFC between an insurance company and a covered banking entity permits the insurance company to exercise remedies under the QFC following the occurrence of a Protected Action with respect to an affiliate of the covered banking entity, then, subject to certain exceptions, the QFC Rules require such provisions to be amended to limit any such exercise of remedies by the insurance company. Additionally, the QFC Rules prohibit a QFC from restricting the transfer of any credit enhancement provided by an affiliate of the covered banking entity (i.e., a guaranty), or certain rights and obligations thereunder, upon or following the occurrence of a Protected Action.

The exceptions to the cross-default requirements do allow for an end-user to exercise its remedies under a QFC if (x) the covered banking entity that is the direct party to the QFC becomes insolvent or fails to satisfy its payment or delivery obligations under either the QFC or another agreement between the parties or (y) the affiliate credit support provider (i.e., the guarantor) fails to satisfy its payment or delivery obligations under the credit enhancement (i.e., fails to make a guaranty payment when due). Additionally, the exceptions also allow for the exercise of cross-default remedies with respect to a Protected Action that affects an affiliate after a short stay period—one business day or 48 hours, whichever is longer—if one of the following four conditions is satisfied: (1) the affiliated credit support provider that remains obligated under the credit enhancement becomes subject to a receivership, insolvency, liquidation, resolution or similar proceeding, other than a Chapter 11 proceeding under the U.S. Bankruptcy Code; (2) a transferee of the affiliated credit support provider itself becomes subject to a Protected Action (subject to certain exceptions related to resolution under the FDIA); (3) the affiliated credit support provider does not remain, and a transferee does not become, obligated to the same, or substantially similar, extent as the affiliated credit support provider was obligated immediately prior to entering into the Protected Action with respect to the related credit enhancement (or any other credit enhancement related to other QFCs between the parties or any other affiliates of the covered banking entity); or (4) in the case of a transfer of the affiliated credit enhancement to a transferee, all of the ownership interests of the covered banking entity directly or indirectly held by the affiliated credit support provider are not transferred to the transferee, or reasonable assurance has not been provided that all or substantially all of the assets of the affiliated credit support provider will be, with limited exceptions, transferred or sole to the transferee in a timely manner.

The cross-default requirements do not apply to a QFC if the QFC does not explicitly provide any default rights that are related, directly or indirectly, to an affiliate of the covered banking entity becoming subject to a Protected Action and does not explicitly prohibit the transfer of affiliate credit enhancement (including any interest or obligations in or under the credit enhancement or any property securing the credit enhancement) to a transferee upon or following such affiliated credit support provider becoming subject to a Protected Action. Thus, to the extent that a QFC does not include any default rights with respect to an affiliate of the counterparty banking entity nor has any credit enhancement from such an affiliate, then the relevant QFC will not need to be amended to address the cross-default requirements.

To the extent amendments are required to current QFCs, the amendments can either be effected through an industry-wide protocol or through bi-lateral amendments agreed between the parties. To the extent an industry-wide protocol is utilized, it should be reviewed carefully to ensure that it does not include broader limitations than those otherwise required by the QFC Rule. See https://www.sidley.com/en/insights/newsupdates/2017/10/federal-reserve-adopts-rule-requiring-gsibs-to-amend-qfc-transactions for a more in-depth summary of the QFC Rule and the differences between the QFC Rule requirements and the ISDA Universal Protocol.

B. U.S. NAIC AND STATE ACTIVITY

1. Status and Implementation of PBR

PBR became operative effective January 1, 2017 in accordance with the NAIC’s Standard Valuation Manual (the “Valuation Manual”), which was adopted by the NAIC in June 2016. As of late January 2018, 47 states have enacted legislation implementing PBR. The only NAIC jurisdictions (with life insurance premiums) that have not passed PBR legislation are Alaska, the District of Columbia, Guam, Massachusetts and New York.

While New York initially opposed PBR, in July 2016, the newly appointed Superintendent of the New York State Department of Financial Services (the “NYDFS”) announced that New York would adopt PBR, but would consider variations to certain aspects of PBR as adopted by the NAIC and would apply a January 2018 effective date, rather than 2017. A bill was introduced in the New York Senate (S.B. 6439-A) authorizing the NYDFS to promulgate regulations adopting

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PBR consistent with the Valuation Manual, except for variations determined to be necessary by the NYDFS. In June 2017, S.B. 6439-A passed the Senate, only to die in Assembly in January 2018.

In August 2017, the Financial Regulation Standards and Accreditation (F) Committee (the “(F) Committee”) adopted a proposal prepared by the Life Actuarial (A) Task Force (“LATF”) identifying the “significant elements” of PBR that must be adopted by states in order to maintain NAIC accreditation. The accreditation requirement is effective January 1, 2020. Also effective January 1, 2020, the NAIC will serve as the experience collection agent on behalf of states. At the NAIC’s Fall 2017 National Meeting, the Principle-Based Reserving (PBR) Implementation (EX) Task Force was disbanded. Ongoing PBR-related work will be overseen by the Financial Condition (E) Committee and LATF.

2. NAIC Evaluates Impact of U.S.-EU Covered Agreement on NAIC Initiatives

The Covered Agreement, which was signed by the United States and the EU in September 2017 and became provisionally effective on November 7, 2017, addresses the following two issues of importance to the NAIC: (a) group supervision of insurers and (b) reinsurance collateral requirements. (See Section IV.A.2 above for discussion regarding the Covered Agreement generally.)

a. Group Supervision of Insurers

The (F) Committee has deferred action on updating its accreditation standards to include the 2014 revisions to the Insurance Holding Company System Regulatory Act due to uncertainty regarding the impact that the Covered Agreement may have on group supervision of insurers. Such revisions address the authority of an insurance commissioner to act as the group-wide supervisor for an internationally active insurance group or to acknowledge the authority of another regulatory official, from another jurisdiction, to so act. The (F) Committee plans to consider the issue further at the NAIC’s Spring 2018 National Meeting.

b. Reinsurance Collateral Requirements

In a major departure from current U.S. insurance law, subject to certain conditions, the Covered Agreement prohibits a U.S. territory (i.e., state) from imposing any reinsurance collateral requirements upon an EU assuming reinsurer that would result in the EU reinsurer receiving less favorable treatment than assuming reinsurers domiciled in the state. Under the Covered Agreement, the U.S. federal government will take an active role in eliminating state reinsurance collateral requirements for EU assuming insurers (within five years) by applying the Covered Agreement on a “provisional” basis before the five-year implementation deadline, pressing states to reduce collateral each year by 20%, and preparing for federal preemption of state laws that still require collateral for reinsurance cessions to EU-domiciled insurers.

Accordingly, the NAIC has commenced a new work stream to adopt reinsurance collateral reform to avoid the federal preemption of state laws governing reinsurance collateral requirements as a result of the Covered Agreement. On February 20, 2018, the Reinsurance (E) Task Force (the “Reinsurance Task Force”) held a public hearing to receive comments on the following approaches to reinsurance collateral reform:

- amending the NAIC Credit for Reinsurance Model Act and Regulation (the “CFR Model Laws”) 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 agreements that might be negotiated pursuant to the Dodd-Frank Act;
- extending similar treatment to reinsurers domiciled in “Qualified Jurisdictions” (for purposes of the reduced collateral requirements applicable to an unauthorized insurer that is approved by states as a “certified reinsurer” under the 2011 amendments to the CFR Model Laws);
- 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; and
- any other considerations to weigh as part of the states’ implementation of the Covered Agreement.

At the hearing, interested parties representing fourteen companies and trade associations reacted to the proposed approaches to reinsurance collateral reform. Certain interested parties that are not supportive of the terms of the Covered Agreement objected to the proposal to apply the reinsurance collateral reform provisions of the Covered Agreement beyond their current scope. Other interested parties advocated for the extension of such terms of the Covered Agreement to other non-U.S. reinsurers and jurisdictions to even the reinsurance playing field. Interested parties generally resisted regulators’ suggestion that additional “guardrails” may be required, arguing that any increased financial solvency risks caused by the elimination of reinsurance collateral is already covered by existing RBC risk factors.

The Reinsurance Task Force is taking the public comments under advisement and has proposed the following next steps to adopt reinsurance collateral reform: (i) for consideration at the NAIC’s Spring 2018 National Meeting, the Reinsurance Task Force plans to propose a model law development request outlining the proposed direction for revisions to the CFR Model Laws; (ii) for consideration at the NAIC’s Summer 2018 National Meeting, the Reinsurance Task Force will prepare draft revisions to the CFR Model Laws; and (iii) at the NAIC’s Fall 2018 National Meeting, the NAIC would vote to approve the proposed revisions to the CFR Model Laws.
3. Unclaimed Property
   a. NAIC Ceases Efforts to Develop Unclaimed Life Insurance and Annuities Model Act

In August 2017, the Life Insurance and Annuities (A) Committee (the “(A) Committee”) voted to disband the Unclaimed Life Insurance Benefits (A) Working Group (the “Unclaimed Property Working Group”) and to cease efforts on the draft Unclaimed Life Insurance and Annuities Model Act (the “NAIC Unclaimed Property Model Act”). The vote followed the Unclaimed Property Working Group’s report regarding the three issues with respect to which the Unclaimed Property Working Group was unable to achieve consensus, namely: (i) the applicability of the NAIC Unclaimed Property Model Act generally (i.e., retroactive versus prospective application), (ii) the applicability of the NAIC Unclaimed Property Model Act to policies that have lapsed within 18 months of the effective date of the NAIC Unclaimed Property Model Act, and (iii) the definition of “death master file match.”

Immediately following such report, Commissioner Dave Jones of California expressed his belief that, even with continued efforts, the Unclaimed Property Working Group would not necessarily be able to achieve consensus on these issues and his agreement with the American Council of Life Insurers (the “ACLI”) that further work on the NAIC Unclaimed Property Model Act would not be a good use of state insurance department resources. While acknowledging that California (which originally chaired the drafting subgroup that prepared the NAIC Unclaimed Property Model Act) had invested significant staff resources in developing the NAIC Unclaimed Property Model Act, California made the motion to disband the Unclaimed Property Working Group and to cease work on the NAIC Unclaimed Property Model Act. The motion passed with virtually no discussion (as no other members of the (A) Committee commented, and representatives from the ACLI and the Center for Insurance Research made only brief remarks and did not object to California’s motion).

The draft NAIC Unclaimed Property Model Act was the result of over three years of work led by the (A) Committee and its working groups and drafting subgroups. The draft NAIC Unclaimed Property Model Act was largely based on the National Conference of Insurance Legislators (“NCOIL”) Model Unclaimed Life Insurance Benefits Act (the “NCOIL Unclaimed Property Model Act”), with some differences based on the requirements contained in the related regulatory settlement agreements that regulators have entered into with several insurers. According to Keane Unclaimed Property Reporting & Compliance Services, as of September 2017, approximately six years after the NCOIL Unclaimed Property Model Act was adopted, a total of 30 states had adopted unclaimed life insurance benefits legislation. Such legislation requires insurers to perform searches of the Social Security Administration’s Death Master File (“DMF”) (or a similar database) in order to become aware of potentially deceased insureds, annuitants and owners of policies, annuities or retained asset accounts.

b. Settlements and Litigation Dealing With Unclaimed Life Insurance Matters

In 2017, three additional life insurance companies or affiliated groups entered into multistate insurance regulatory settlements with insurance regulators. The same companies also entered into multistate settlements with unclaimed property agencies and auditors. This brings the total publicly announced multistate settlements to 27 insurance regulatory and 29 unclaimed property agency settlements, with two insurer groups having been determined to be in compliance (and therefore, no insurance regulatory settlements were entered into). In addition to the multistate settlements, some states are individually pursuing similar investigations of life and annuity insurers.

Cases examining the extent to which regulators may compel life insurers to produce in-force policy records for a comparison against the DMF are progressing towards resolution. In United Ins. Co. of Am. v. Frerichs, No. 15-CH-998 (Ill. Cir. Ct.), the voluntary dismissal of certain insurers’ objections to the DMF-matching efforts of a state treasurer became final. A counterclaim by the treasurer seeking a declaration that the treasurer has the statutory authority to conduct an examination of the companies, either directly or through a contract auditor, remains pending.

Finally, in Thrivent Financial for Lutherans v. Yee, Nos. A142332 & A145900 (Cal. App. Jul. 17, 2017), a California appellate court affirmed the dismissal on mootness grounds of the California Controller’s action against an insurer following a trial court ruling denying the Controller’s motion for a preliminary injunction to compel the insurer to produce in-force policy records for a DMF search.

i. Health Insurance Regulation – ACA Risk Corridors and Cost Sharing Reduction Litigations

Since early 2016, 52 lawsuits—including one that has been certified as a class action—have been filed by insurers against the U.S. government for failure to pay amounts that would be owed them under the formula found in the ACA’s risk corridors statute and regulations. The risk corridors program was intended to protect insurers from extreme gains and losses during the initial years that major substantive changes were implemented under the ACA. Under the three-year program in effect from 2014 to 2016, qualified health plans with lower than expected claims are required to make payments to CMS, while plans with higher than expected claims receive payments from CMS. On June 30, 2016, the government announced that the aggregate corridors payment shortfall exceeded US$12.3 billion for the combined 2014 through 2016 years.

These cases were all filed in the Court of Federal Claims, with two courts ruling in favor of the insurer and three ruling in favor of the government. Oral argument in two of the cases up on appeal were heard in January 2018 by the U.S. Court of Appeals for the Federal Circuit, with decisions expected by fall 2018.

Litigation has also ensured over the U.S. government’s October 2017 decision to stop cost sharing reduction payments to health insurers. Since then, five lawsuits, including one putative class action, have been filed against the government for failure to pay amounts.
that would be owed to health insurers under the ACA’s cost sharing reduction statute and regulations. The payments are designed to make health care under the ACA more affordable for lower-income citizens by reimbursing insurers for co-pays and other cost-sharing payments normally borne by insureds. However, in October 2017, the U.S. Attorney General’s office issued a memorandum finding that the cost sharing reduction payments were unconstitutional because there was no appropriation from Congress to fund them. Four of the lawsuits were filed by private insurers in the Court of Federal Claims. The fifth lawsuit was filed in the U.S. District Court for the Northern District of California by a collection of states. The court denied the states’ request to immediately enjoin the government from ceasing the payments. Briefing in the case is expected to run through summer 2018.

4. Life Insurance and Annuities
   a. Variable Annuity Regulatory Framework

The Variable Annuity Issues (E) Working Group (“VAIWG”) continues its work to revise the regulatory framework governing variable annuities, particularly the capital charge requirements in C3 Phase II (“CP2”), and reserve requirements in Actuarial Guideline XLIII (“AG 43”) (collectively, the “VA Regulatory Framework”). The VAIWG has been working on such revisions since 2015, with the assistance of its consultant, Oliver Wyman. In its initial evaluation, Oliver Wyman determined that the use of captive structures by VA writers could be decreased if certain changes were made to the existing VA Regulatory Framework. So far, Oliver Wyman has performed two quantitative impact studies (“QIS”) to determine whether the various changes proposed since 2015 are feasible from a time/cost perspective. The VAIWG held a four-hour meeting in December 2017 to discuss proposed revisions and will be considering additional comments at the NAIC’s Spring 2018 National Meeting.

b. Annuity Suitability “Best Interest” Standard
   i. NAIC Activities

In November 2017, the Annuity Suitability (A) Working Group (the “ASWG”) released its initial draft of proposed revisions to the NAIC’s Suitability in Annuity Transactions Model Regulation (the “SAT”). Among other things, the proposed revisions prohibit insurance producers (or insurers) from making a recommendation to a consumer regarding the purchase of an annuity unless the recommendation is suitable and in the “best interest” of the consumer at the time it is made on the basis of the facts disclosed by the consumer as to his or her investments and other insurance products and as to his or her financial situation and needs, including the consumer’s suitability information. “Best interest” is defined as “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,” and does not mean “a resulting recommendation is the least expensive annuity product, or the annuity product with the highest stated interest rate.”

Interested parties have expressed numerous concerns regarding the proposed revisions, including the difficulty in applying both a “best interest” and a “suitability” standard, the subjective nature of terms such as “reasonable,” and how the best interest standard should be harmonized with each of (x) the best interest standard included in the Fiduciary Rule released by the U.S. Department of Labor in April 2016 (see Section IV.A.5 above) and (y) the rules issued by the Financial Industry Regulatory Authority (“FINRA”) addressing suitability. The ASWG is aiming to finalize its revisions in time for the (A) Committee to consider them at the NAIC’s Spring 2018 National Meeting.

   ii. NYDFS Proposed Amendment to Regulation 187 (Suitability in Annuity Transactions)

In late December 2017, the NYDFS proposed amendments to its suitability in annuity transactions regulation (“Regulation 187”). Currently, Regulation 187 requires that a consumer’s insurance needs and financial objectives be “appropriately addressed.” The proposed amendments would additionally require that an insurance producer “help ensure that a transaction is in the best interest of the consumer.” Further, Regulation 187, as amended, would apply not only to annuities, but to any proposed or in-force policy, where “policy” would be defined to include (subject to certain exceptions) a life insurance policy, annuity contract, or a certificate issued by a fraternal benefit society or under a group life insurance policy or group annuity contract, delivered or issued for delivery in New York.

The proposed “best interest” standard is similar in concept to the best interest standard contained in the Fiduciary Rule (see Section IV.A.5 above). However, unlike the Fiduciary Rule, the NYDFS’s proposed best interest standard would apply regardless of whether an insurance producer receives a commission, the source of an annuity’s funding, or the type of annuity. It would also apply to life insurance transactions, unlike the Fiduciary Rule and the NAIC’s proposed revisions to the SAT, which only apply to certain annuities (see Section IV.B.4.b.i above).

c. NYDFS Adopts New Regulation Limiting Premium Increases for In-force Life Insurance Policies

In September 2017, the NYDFS adopted regulations that impose certain requirements on insurers when changes are to be made to the non-guaranteed elements (“NGEs”) of life insurance policies and annuities delivered or issued for delivery in New York (“Regulation 210”). Regulation 210, which becomes effective March 19, 2018, addresses concerns regarding increases in the cost of insurance (“COI”) on in-force, older life insurance policies, including the impact to policyholders (particularly senior citizens and other persons on fixed incomes) when insurers address COI increases by raising premiums/reducing benefits on in-force insurance policies.

Regulation 210 requires that insurers submit a notification to the NYDFS prior to implementing any change in the scale of NGEs of a policy that may have an adverse effect on policy values. Insurers must also establish board-approved criteria for determining non-guaranteed charges or benefits and conduct regular reviews of anticipated experience factors and NGEs. Regulation 210 also: (i) imposes certain rules concerning readjustments to NGEs relating to differences in anticipated experience factors with respect to expenses, mortality, investment income, policy claims, taxes, lapses...
and persistency (policies that do not lapse); and (ii) details required disclosures to policy owners in applications, illustrations and/or policy forms.

5. NAIC Activity Relating to International Insurance Activities – NAIC Developing Group Capital Standard

The NAIC continues its work to develop a group capital calculation for U.S. regulators to use in evaluating risks and the financial position of an insurer’s holding company system. The group capital calculation is intended to provide regulators with a consistent method of calculating group capital and will serve as a baseline quantitative measure for group risks. While regulators currently analyze U.S. insurance groups, they do not have a consolidated financial measure in performing their analyses. The group capital calculation will be based on an RBC aggregation methodology.

Throughout 2017, the Group Capital Calculation (E) Working Group (the "GCC Working Group") has considered, among other matters, the treatment, for purposes of the group capital calculation, of captives used to finance excess reserve requirements associated with blocks of level premium term insurance subject to Regulation XXX or universal life products with secondary guarantees subject to Regulation AXXX. At issue is whether the group capital calculation will recognize the asset and liability valuations permitted under PBR and AG 48, or whether the group capital calculation will essentially require unwinding the captive transaction.

Specifically, in a memorandum dated October 31, 2017, the chair of the GCC Working Group exposed for comment the following suggested approach with respect to the treatment of XXX/AXXX captives for purposes of the group capital calculation (the “Captives Memo”): (1) “[w]e use a valuation that results in essentially ‘looking through’ the transaction all together (i.e., unwind the captive transaction)”); (2) “[t]his would include requiring the calculation for the XXX/AXXX captive to report the liabilities consistent with the valuation of the direct writer then requiring the use of SAP on the captive assets;” and (3) “[t]his could also include allowing the captive valuation, but requiring some type of on-top adjustment elsewhere in the calculation (and/or RBC charges related to non-qualifying SAP assets) to get to a similar net capital valuation of the XXX/AXXX as required within 2 [above].” While the proposal set forth in the Captives Memo is supported by the NYDFS (which continues to enforce a moratorium on captive reinsurance), industry has objected to the proposal as inappropriate insofar as the resulting group capital calculation would disregard the financial statements and capital calculations used by state regulators and other stakeholders to evaluate (in accordance with domestic state legal entity rules) the capital adequacy of insurers at the legal entity level. Resolution of these open questions continues to be a pressing question for the industry.

6. NAIC Continues Work on RBC Initiatives

Various NAIC working groups are (a) considering changes to the calculation of RBC when an insurer receives a Federal Home Loan Bank ("FHLB") advance and posts related collateral; (b) implementing a catastrophe risk factor ("Rcat") in the property-casualty RBC formula, effective for year-end 2017, and considering whether to include additional perils in the Rcat; and (c) implementing a revised property-casualty RBC blank and instructions, effective for year-end 2018, that reference a new credit risk charge for reinsurance recoverables as a component of the credit risk charge.

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a. RBC Charge for Assets Pledged as Collateral for FHLB Advances

Currently, the assets posted as collateral for an FHLB advance remain on the insurer's balance sheet and generate an RBC amount based on the credit risk of the asset. The FHLB advance is recorded as either a borrowing or funding agreement, and it is generally included in the insurer's C-3 modeling to generate an RBC amount for asset-liability mismatch. Additionally, since such assets are classified as “non-controlled assets,” an RBC factor of 1.3% is applied to the collateral (in addition to any other RBC amounts for the assets and liabilities).

The Life Risk-Based Capital (E) Working Group is considering a proposal from the ACLI that would result, in relevant part, in the following RBC changes related to FHLB advances:

- For FHLB advances subject to C3P1 Cash Flow Testing, a factor of zero would apply to the assets pledged as collateral, up to the amount of the FHLB advance, and a factor equal to the NAIC's credit risk charge for FHLB as a counterparty would apply to assets pledged in excess of the amount of the FHLB advance. For FHLB advances that are not subject to C3P1 Cash Flow Testing, the NAIC's credit risk charge for FHLB as a counterparty would apply to the entire amount of pledged collateral supporting the advance.

- The amount of assets pledged in excess of the amount of the FHLB advance (which are available to be recalled by the insurer), would not be considered non-controlled asset risk and would be excluded from the C-0 RBC risk charge.

- Collateral supporting certain FHLB spread-lending activities would be subject to a higher non-controlled asset charge (equal to the factor for a Baa Corporate Bond asset factor) if the amount of the related FHLB advance exceeds 5% of the insurer's total net admitted assets, unless the insurer has received authorization for the higher advance amount from its domiciliary state insurance regulator.

b. Catastrophe Risk Factor

After 10 years of discussions, in April 2017 the NAIC added an “Rcat” factor to the property-casualty RBC formula, effective for year-end 2017. Rcat computes Total RBC after Covariance. The Rcat is currently a combination of earthquake and hurricane risks, but the Property and Casualty Risk-Based Capital (E) Working Group is considering whether to include additional catastrophe perils. Its Catastrophe Risk (E) Subgroup has identified the following as potential additions: (i) tornado (severe convective storm); (ii) flood (non-U.S., and U.S. as private market develops); (iii) terrorism; (iv) wildfire; (v) winter storm; (vi) cyber risk; (vii) fire following earthquake; (viii) workers' compensation earthquake exposure; and (ix) industrial accident.
c. Credit Risk Charge for Reinsurance Recoverables

In August 2017, the NAIC adopted a proposal to implement a revised property-casualty RBC blank and instructions, effective for year-end 2018, which references a new method for calculating the credit risk charge for reinsurance recoverables. Calculation of the credit risk charge depends on: (i) the financial strength rating assigned to the reinsurer from which balances are due; and (ii) whether such amounts are collateralized or uncollateralized. A reinsurer’s financial strength rating is the same rating assigned to it for purposes of determining the amount of required collateral for a cedent to obtain credit for reinsurance (e.g., Secure-1, Secure-2, Secure-3, Secure-4, Secure-5, Vulnerable-6). Reinsurance balances receivable on reinsurance ceded to non-affiliated companies (excluding certain pools) and to alien affiliates are subject to the charge. The following types of cessions are exempt from the charge: (x) cessions to state-mandated involuntary pools and associations or involving federal insurance programs; and (y) cessions to U.S. parents, subsidiaries and affiliates.

d. Operational Risk

The NAIC continues efforts to include an “operational risk” component to RBC formulas for health, life and property-casualty insurers. A new RBC charge would reflect operational risk to the extent such risk is not already reflected in existing RBC risk categories. The primary focus is on “growth risk” (where there is an increase in premium that exceeds a certain threshold in a given time period) and “basic operational risk” (a charge that would be a percentage of total RBC and that would go into effect if it exceeds the “business risk charge” that is already included in the RBC formula).

In April 2017, a structure was finalized that would enable a so-called “add-on” methodology to be implemented to calculate operational risk. An appropriate add-on/factor would take into account areas where operational risk may overlap with other types of risk already captured in the RBC formulas (for example, the C-4 life business risk charge is similar to operational risk, such that an offset would be needed). In May 2017, the Operational Risk (E) Subgroup adopted a 3% add-on for basic operational risk in all RBC formulas and recommended that 1% (or 1.5%) be applied in 2017 and 3% be applied starting in 2018. However, on a conference call in June 2017, the Capital Adequacy (E) Task Force determined that additional time was needed to consider an appropriate charge and, therefore, made the operational risk charge “0” for purposes of 2017 reporting. The 0% factor serves as a placeholder until the NAIC determines how much extra capital should be required starting in 2018 (or later) and how to resolve an issue concerning “double counting” of C-4a (business risk) capital of U.S. life subsidiaries where the parent company also files RBC.

7. NAIC Exploring Insurers’ Use of Big Data

In its continued efforts to evaluate the regulatory framework used to oversee insurers’ use of consumer and non-insurance data in connection with insurance underwriting, rating, claims and marketing, the initial focus of the Big Data (EX) Working Group (the “Big Data Working Group”) has been on the use of data for rating and claims in private passenger automobile insurance and homeowners insurance.

The Big Data Working Group identified certain model rating laws, model unfair trade practices laws and model unfair claims settlement practices laws as prescribing the existing regulatory framework that applies to such issues. To inform the Big Data Working Group’s analysis of whether revisions to the current regulatory standards are required, the Big Data Working Group will survey state insurance regulators to collect information on whether states have specific prohibitions regarding insurers’ use of certain data elements in connection with underwriting and rating private passenger automobile insurance and homeowners insurance.

The Big Data Working Group has also proposed the formation of a Predictive Analytics (E) Working Group (the “PAWG”), consisting of five to ten regulatory authorities, to, among other things, draft potential changes to the Product Filing Examiners Handbook to address best practices for review of predictive analytics and models used by insurers to justify rates. For example, it has been proposed that the PAWG would formulate a checklist of required data that insurers must include in their SERFF rate filings for any models used in their rating plans. The checklist would facilitate a state’s determination of whether the model should be sent to the PAT for review (e.g., if it is a new model or involves updates to a previously approved model). If a model were referred to the PAT, the PAT would issue either a report to the state with its findings or an objection letter to the insurer requesting additional information. The PAT would maintain a record of all models reviewed for access by the states.

Stakeholders have expressed several concerns with the proposed PAWG/PAT structure, including: (a) the structure delegates regulatory functions that are within the purview of the states to the NAIC without legal authority; (b) confidentiality and trade secret protections for intellectual property embedded in the models are lacking; (c) the qualifications of NAIC staff to review complex models are unclear; and (d) innovation and speed-to-market would be inhibited.

8. NAIC Developing Model Act Regarding Travel Insurance

Through the Travel Insurance (C) Working Group (the “TIWG”), the NAIC is developing the NAIC Travel Insurance Model Act (the “NAIC Travel Model Act”), which is intended to provide a uniform, comprehensive framework for regulating the marketing and sale of insurance products related to travel protection. The TIWG is using, as a template, the NCOIL Limited Lines Travel Insurance Model Act (“NCOIL Travel Model Act”), which generally addresses licensing requirements related to selling, soliciting or negotiating travel insurance. Forty states have adopted some form of the NCOIL Travel Model Act. In March 2017, NCOIL adopted amendments to
the NCOIL Travel Model Act, now known as the “Travel Insurance Model Act.” As amended, the NCOIL Travel Model Act provides a comprehensive framework for regulating travel insurance and other travel-related products, prescribing rules related to, among other things, premium taxes, form and rate filing, the competitiveness of the travel insurance market and related sales practices (including a prohibition against requiring consumers to opt out of the purchase of travel insurance).

The current draft of the NAIC Travel Model Act is similar to the amended NCOIL Travel Model Act, with the key differences being: (a) the deletion of the “competitive market” section of the amended NCOIL Travel Model Act; and (b) provision for electronic delivery of insurance materials to start a policyholder’s 10-day “free look” period. The current draft also retains the ban on “opt-out marketing,” such as requiring consumers to affirmatively deselect insurance coverage (such as by unchecking a box) when booking travel plans.


Over the past year, the Valuation of Securities (E) Task Force (“VOS Task Force”) worked on proposed amendments to the Purposes and Procedures Manual of the NAIC Investment Analysis Office (the “P&P Manual”) which would provide the SVO with the power to override ratings of nationally recognized statistical rating organizations for filing exempt and private letter rated securities. The proposal would have amended the P&P Manual to add a verification process for private letter rating and filing exempt processes and would have transferred responsibility of such procedures from insurance companies to the SVO. In response to various concerns raised against the proposed amendments, the VOS Task Force decided, rather than pursuing the proposed amendments, to instead continue discussions on enhancements to the filing exempt and private letter rating processes. Members of the VOS Task Force identified the following as key policy decisions necessary to effectuate the enhancements: (a) provide a process for resolving discrepancies between NAIC and insurer designations and establish “reasonable grounds” for using such a process; and (b) allow the NAIC Investment Analysis Office (the “IAO”) to make changes to automated filing exempt designations in the case of errors computing a filing exempt designation by the automated process or correcting an anomaly in the NAIC designation; and (c) include private letter ratings in either rating agency feeds or filed with the IAO to be manually added to the filing exempt database.

With these key policy decisions in mind, in November 2017, the VOS Task Force adopted amendments to the P&P Manual. While the revisions retain the existing filing exempt rule and process, the amendments extend the processes to securities subject to private letter ratings. In addition, the amendments remove (i) the discretion of the SVO to ignore ratings issued by NAIC credit rating providers when translating credit ratings into NAIC designations and (ii) the SVO’s authority to require an insurer to file a security with the SVO even if the security meets the filing exempt criteria as set forth in the P&P Manual.

10. NAIC Addresses the Potential Impact of Long-Term Care Insurance Insolvencies on Guaranty Funds

In December 2017, the NAIC adopted amendments to the Life and Health Insurance Guaranty Association Model Act (the “Guaranty Fund Model Act”) for the limited purpose of addressing issues related to long-term care (“LTC”) insurer insolvencies. At least 12 state insurance departments and 35 interested parties participated in the development of the amendments. The amendments, in relevant part, make the following changes to the assessment base for LTC insurer insolvencies:

- **Merge the life (and annuities) and health insurance lines of business.** This was agreed in order to resolve the perceived inequity of health insurers paying the majority of the assessment for a line of business they generally don’t write. (Although LTC insurance is primarily written by life insurers, because LTC insurance is classified as a health product, historically only health insurers—the majority of which do not sell LTC insurance—were subject to assessment for LTC insurance insolvencies.)

- **Include health maintenance organizations.** Health maintenance organizations (“HMOs”) historically were excluded from the scope of the Guaranty Fund Model Act. However, given the increasing similarities between HMO products and health insurance policies, health insurers argued that HMOs would have a competitive advantage over health insurers if HMOs continued to be excluded from the scope of the Guaranty Fund Model Act (particularly for purposes of the assessment base for LTC insurer insolvencies). Such amendments were adopted despite vigorous opposition by HMO trade organizations.

11. NAIC Considers Prohibiting the Use of Pre-Dispute Mandatory Arbitration, Choice-of-Law and Choice-of-Venue Clauses in Personal Lines Insurance Policies

The Pre-Dispute Mandatory Arbitration Clauses (D) Working Group (the “Arbitration Clauses Working Group”) has appointed a drafting group composed of members from Connecticut, New Mexico, Ohio and Oregon to prepare a draft bulletin to prohibit the use of pre-dispute mandatory arbitration clauses, choice-of-law provisions and choice-of-venue provisions in personal lines insurance policies. The Arbitration Clauses Working Group also has authority, under its charges, to consider such issues with respect to commercial lines insurance policies. As of early February 2018, a draft bulletin has not been exposed for comment.

C. INTERNATIONAL (NON-U.S.) INSURANCE ISSUES

1. What are Insurers Doing in the Midst of the Brexit Negotiations?

On March 29, 2017, the UK government triggered Article 50 of the Treaty on European Union, setting into motion the two-year timeframe of negotiations to settle the terms of the UK’s exit from the EU. The UK is officially set to leave the EU at the end of March 2019, subject to any agreed extension.
Despite being halfway through the two-year period before the UK no longer forms part of the EU, the progress of negotiations has been slow. Having provisionally agreed on certain "divorce" issues, discussions are now moving to the future relationship between the two and a plan for a transition period after March 29, 2019 to allow businesses to prepare for the new regime post-Brexit.

One of the major concerns for the insurance industry resulting from Brexit is the potential loss of passporting rights. "Passporting" allows firms in one EU member state to establish branches or provide services into another member state without the need for authorization by the local regulator. The loss of passporting rights would also affect EU insurers that underwrite risk in the UK.

Given the uncertainty surrounding the outcome of the negotiations, over the course of 2017 UK-headquartered insurers have been preparing for a "hard Brexit" scenario, which has also been prompted by the PRA letter to firms in April 2017 requesting that firms set out contingency plans for the UK’s withdrawal from the EU. This has led to a number of insurers establishing subsidiaries elsewhere in Europe, with Luxembourg being the favored location. AIG, Hiscox, RSA and Tokio Marine Group, amongst others, have all chosen Luxembourg as the seat of their EU insurance business. Others, such as Beazley and XL Catlin, have opted for Ireland, with Aviva turning their Irish branches into subsidiaries. Lloyd’s of London announced in March 2017 that it had selected Brussels as the location to establish its EU subsidiary, due to its robust regulatory framework, and has recently revealed that it is aiming to commence operations there by as early as January 1, 2019. MS Amlin and QBE have also chosen Belgium as their EU hubs.

In order to assist firms with their planning assumptions, on December 20, 2017, HM Treasury announced that it will, if necessary, bring forward legislation "which will enable EEA firms … operating in the UK to obtain a “temporary permission” to continue their activities in the UK for a limited period after withdrawal" and “to ensure that contractual obligations, such as insurance contracts, which are not covered by the regime, can continue to be met.”

The PRA welcomed this announcement and on the same day it issued a “Dear CEO” letter setting out its views on firms’ planning assumptions. The starting point is that, in the absence of continued passporting rights post-Brexit, firms currently benefitting from passporting by exercising rights to establish a branch or provide services into the UK (“inbound firms”) will need to obtain PRA authorization to carry on performing such activities in the UK.

The PRA recognized the positive outcome of the European Council meeting in December 2017 where there was agreement of the need to negotiate an implementation period during which firms could continue undertaking cross-border activity between the UK and the EU in the same way it is currently doing. This would of course mean the UK and the EU working closely together and in cooperation to achieve this.

In its letter, the PRA invited firms to submit applications for authorization from January 2018 noting that the authorization process may take up to 12 months from the point of application. Inbound firms are also encouraged, where they have not already done so, to engage with the PRA in pre-application discussions particularly given the scale of the authorization process. In seeking authorization, firms will need to meet the “threshold conditions” and in considering whether these conditions have been met, the PRA will look at the extent and nature of the firm’s presence in the UK, including in relation to its mind and management.

Although the PRA has welcomed the UK government’s announcement as providing the regulators with the means to establish a temporary permissions regime, firms are encouraged to begin preparing for authorization in the manner stated above, since the PRA only intend to use the temporary permissions regime as a fallback measure.

On December 21, 2017, the European Insurance and Occupational Pensions Authority ("EIOPA"), the EU insurance regulator, issued an opinion paper on service continuity in insurance in light of Brexit. The aim of the opinion is to remind supervisory authorities and firms to take the necessary steps to avoid insurance activities being performed without authorization and to ensure that cross-border insurance contracts concluded before the UK withdraws from the EU will continue to be fulfilled once the UK leaves the single market. Since the main objective of insurance supervision is the protection of policyholders and beneficiaries, EIOPA is keen to avoid exposing policyholders to significant uncertainty and instead wants firms to take mitigating actions before the withdrawal.

In order to assist firms in achieving service continuity following Brexit, EIOPA has set out some options in its Opinion:

- the transfer of insurance contracts of UK firms with policyholders in the remaining EU member states (referred to as the EU27) to an EU-based insurance subsidiary;
- the transfer of insurance contracts of EU27 firms with UK policyholders to a UK-based insurance subsidiary;
- the establishment of a third country branch in the UK or in the EU27 member state of the policyholder; and
- with regard to UK firms in the legal form of a European company, the change of domicile of the company to an EU27 member state.

EIOPA recognizes that these options will require preparatory measures and may be used by firms in some combination with each other to accomplish the desired objective.

From a UK perspective, insurers intending to transfer their EU books of business pursuant to Part VII of the Financial Services and Markets Act 2000 (“Part VII Transfers”) to an EU-established entity should aim to do so sooner rather than later, particularly since it is anticipated that the number of Part VII transfers will increase significantly as firms look to reorganize their portfolios. This will put the PRA under significant pressure and will increase the timeline of a Part VII, which can typically take between 6 and 12 months depending on the complexity of the transfer, to between 12 and 18 months if not longer. In which case, those firms that have yet to
commence the process of transferring their business under Part VII may well be out of time for ensuring that the business is effectively relocated by the time the UK leaves the EU.

Although the UK Government is trying to accommodate EU insurers underwriting risks in the UK through the availability of a temporary permissions regime. The EU, on the other hand, has a different approach. Michel Barnier, the EU’s chief negotiator, has stated that “there is not a single trade agreement that is open to financial services. It doesn’t exist … [this is the consequence of] the red lines that the British have chosen themselves. In leaving the single market, they lose the financial services passport.”

A transition period would of course be useful, if not fundamental, for those insurers who have not yet set in motion their contingency plans enabling them to be compliant post-Brexit. However, many of the larger insurers are already in the midst of a reorganization given the continuing uncertainty of the negotiations. Whether a transition period is implemented remains to be seen, although insurers appear to be working towards a worst case scenario and looking to have everything in order for when the UK officially leaves the EU.

2. Lloyd’s Update

This will be a significant year for Lloyd’s. Lloyd’s continues to press ahead with its Brexit contingency planning as the UK government and the EU have yet to provide clarity about the scope of any transition period following the UK’s exit from the EU in March 2019. With the ongoing uncertainty surrounding the treatment of financial services both within and following any transition period, Lloyd’s has had to act to safe-guard its international status by forming its new European insurance company, based in Belgium, and by submitting its application to the Belgian regulator with plans to be ready to underwrite from January 1, 2019.

Lloyd’s has extensive experience of building both local presences and local establishments away from its base in London, investing in its regulatory relationships worldwide and building diverse models depending upon the relevant local regulatory environment. Lloyd’s international network of licenses, representative offices, local insurance and reinsurance companies and, in certain countries, status in that jurisdiction’s legislative framework is, together with its financial strength and ability to underwrite complex risks (not least catastrophe cover), one of its key selling points.

By way of example, Lloyd’s first had a reinsurance company in mainland China in 2007, which since 2010 has become an insurance company. It has locally based underwriters in divisions reinsured by specific syndicates in its London base underwriting risks in the Shanghai and, from 2011, the Beijing municipal administrative regions. In addition to China, Lloyd’s Asia hub, based in Singapore since 1999, operates on a service company model, with managing agents of syndicates having locally based and regulated service companies underwriting on behalf of their syndicates (collectively US$579 million gross written premium in 2016). As of April 2017, Lloyd’s has a branch in India and Lloyd’s is authorized to underwrite certain reinsurance on a cross-border basis.

In the Middle East, Lloyd’s opened in the Dubai International Financial Centre in 2015 (combining new and existing Lloyd’s businesses) and again operates via locally based and regulated services companies and also Lloyd’s coverholders (akin to managing general agents). This base provides specialist reinsurance cover in the Middle East and the North African regions. The latter has recently been supplemented by the opening of a new Lloyd’s office in Casablanca, Morocco.

In South America and Latin America, Lloyd’s again has good local representation. For example, it was the first reinsurer authorized in Brazil after the opening of the Brazilian reinsurance market in 2008.

In the United States, one of Lloyd’s most important markets, Lloyd’s has licenses in Illinois, Kentucky and the U.S. Virgin Islands, and is an approved surplus lines insurer in all U.S. states and territories (the largest surplus lines insurer in the United States) and an accredited reinsurer in all 50 states (the largest non-U.S. domiciled reinsurer).

Furthermore, in Canada, Lloyd’s first had a representative office in 1932 and now has a substantial network of commercial trade rights and licenses.

Lloyd’s international strength and capacity for its London based syndicates to underwrite globally is key to its status and a significant plank of its Vision 2025. It will be interesting this year to see how its model for Europe evolves in light of its other approaches internationally and in the context of the ongoing UK/EU negotiations, political and regulatory. We are likely to see a hybrid of its current China, Asia hub and U.S. models, with its EU insurance company underwriting risks that are then reinsured by its syndicates in London. One thing is certain—Lloyd’s will be doing everything it can to retain its current operating model and to maintain market stability and efficiency in order to safeguard its international status and what was 11% of its gross written premium in 2015. A reasonably notable (albeit not material to Lloyd’s overall or, indeed, EU annual gross written premium) exception being its EU life insurance business, which has not been included in Lloyd’s Brexit contingency planning and will cease to be underwritten following Brexit and any transition period.

A further vital element of Lloyd’s Vision 2025 is that its “underwriting and claims management will be supported by an industry-leading infrastructure and service proposition with efficient central services and seamless processing.” Lloyd’s remains for the most part a paper-based market. This year will be important for the London Market, of which Lloyd’s forms a major part, from the perspective of market transformation. 2018 is the year of adoption of the London Market “Target Operating Model” (“TOM”). TOM is designed to make it easier to do business in the London Market. In particular, Placing Platform Limited (“PPL”), a key insurtech reform by the London Market aimed at facilitating face-to-face negotiation by electronic risk capture, placing, signing and closing, will be rolled out more broadly, with a key aim being to reduce the current substantial expense ratio with the Lloyd’s and wider London Market as a whole. At this point 60% of financial and professional risks in the London Market are placed electronically, but wider adoption has not been implemented as extensively as Lloyd’s would like. Inga Beale, Lloyd’s CEO, confirmed in February of 2018 that Lloyd’s proposes to mandate the use of electronic placement on a phased basis over time. The London Market Group, an industry body, has recently hailed the closing of the Aon Client Treaty facility for 2018 as a major watershed for PPL,
The IMD has been part of the EU regulatory landscape since January 14, 2005. An overhaul of the IMD provisions was prompted by: (i) inconsistency in the way the IMD regime had been implemented by member states; (ii) development of a more complex insurance market and product offerings since the IMD was enacted; and (iii) a greater focus on consumer protection across all financial sectors since the 2008 financial crisis.

3. Insurance Distribution Directive
On December 14, 2015, the European Council formally adopted the Insurance Distribution Directive (the “IDD”). The IDD will replace the Insurance Mediation Directive 2002/92/EC (the “IMD”) and introduce refreshed minimum regulatory standards for insurance sales in the EU. The IDD came into force on February 22, 2016 and the deadline for member states to apply and transpose the IDD into their national laws was due to be February 23, 2018. However, the European Council has recently agreed to delay the transposition deadline to July 1, 2018 and the application date to October 1, 2018, following calls from the European Parliament and member states to allow: (a) member states additional time to properly implement the new IDD regulatory framework; and (b) the insurance industry more time to prepare for the IDD and the changes that will need to be made to comply with it.

The key amendments under the IDD are set out below:

- **Direct sellers to be in scope.** The IDD will apply not only to intermediaries but also to insurers that sell directly to their customers, including sales through aggregator websites, and certain ancillary sales (collectively, “distributors”). This extension of scope reflects the view that consumer protection should be the same regardless of the channel through which customers buy an insurance product.

- **Enhanced professional requirements and internal policies.** The IDD includes provisions that ensure a high level of competency and continuing professional development among insurance distribution firms and their employees. This includes the requirement for a minimum of 15 hours per year for professional training and development and the documentation and regular review of internal policies and procedures relating to competency and continuing development.

- **“Customer’s best interests” principle; conflict management and product governance rules.** The IDD introduces a general principle that insurance intermediaries and distributors must “always act honestly, fairly and professionally in accordance with the best interests of its customers,” and they are not to remunerate, incentivize or assess the performance of their employees in a way that conflicts with this duty. It also requires insurers and intermediaries that design insurance products to maintain, operate and periodically review the product approval process.

  - **New remuneration disclosures.** The IDD requires that insurance intermediaries and distributors now disclose certain information about the nature of remuneration received, the basis of fees and whether any commission or other type of arrangement exists, prior to the conclusion of a contract.

  - **New cross-selling rule.** In the context of the IDD, a “cross-selling practice” involves an insurance product being offered together with a non-insurance product or service as part of a package or the same agreement. The new requirements relating to this practice vary depending on whether the insurance product is the main or ancillary product within the package and include, for example, a requirement to inform the customer whether it is possible to buy the different components separately, among others.

  - **Enhanced sales standards for insurance-based investment products (“IBIPS”).** Under IDD, distributors of IBIPS will have: (i) increased disclosure requirements relating to the nature and risks associated with the IBIP; (ii) a requirement to assess the appropriateness of an IBIP for each customer (for non-advised sales); (iii) conduct suitability assessments (for advised sales); and (iv) an obligation to provide periodic reports to customers.

b. Developments in the Establishment of Delegated Acts, Technical Standards and Guidelines as Required Under the IDD

The IDD gives the European Commission (the “Commission”) the power to adopt delegated acts relating to: (i) product oversight and governance (“POG”); (ii) management of conflicts of interest; (iii) the conditions under which inducements can be paid or received; and (iv) the assessment of suitability and appropriateness and reporting to customers in relation to the distribution of IBIPS. Delegated acts can be implemented as either Commission delegated regulations or decisions, but to date, the IDD delegated acts have taken the form of Commission delegated regulations, meaning they apply directly to member states without the requirement for transposition into national law.

On February 24, 2016 the Commission asked the EIOPA to provide technical advice on the possible IDD delegated acts. EIOPA has since published its final technical advice on February 1, 2017, outlining its proposals for the delegated acts. As part of the process, EIOPA published a consultation paper on the draft technical advice and held a public hearing with key stakeholders in September 2016 to discuss the issues that were under consultation.

Following the publication of EIOPA’s final technical advice, the Commission adopted two delegated regulations (one relating to POG and the other to the suitability and appropriateness of distributing IBIPS), in September 2017, which were subsequently
approved by the European Parliament and European Council. These delegated regulations were due to come into force on February 23, 2018, along with the IDD.

c. Amendments to Application Date and Transposition Date

Following concerns from a number of member states that firms, especially smaller firms, would not be ready for the application of the IDD due to the finalization and adoption of the IDD delegated regulations in late 2017, the European Parliament adopted two decisions, which called on the Commission to adopt legislation to delay the IDD application date to October 1, 2018, but keep the transposition date at February 23, 2018. Although the Commission felt that firms have already been given sufficient time to adapt, given that 16 member states supported the European Parliament’s proposal, the Commission adopted, in an explanatory memorandum on December 20, 2017, legislative proposals to delay the application of the IDD (including the delegated regulations relating to POG and IBIPs) by seven months to October 1, 2018, to give the sector more time to prepare. The Commission did not, at this stage, agree to postpone the transposition date of the IDD.

However, in the context of considering the delay of the application date, many member states expressed concerns about keeping the transposition date at February 23, 2018. In fact, these concerns were raised in a letter to the Commission in November 2017, whereby member states sought to postpone the transposition date as well as the application date. The European Parliament has since announced that it is “positively” considering such a postponement by a few months to July 1, 2018, to allow member states the time to properly implement their new IDD regulatory framework.

In the last few weeks, the European Council has been considering these propositions and on February 14, 2018, confirmed that an agreement to delay the transposition date to July 1, 2018 and the application date to October 1, 2018, has been reached. This delay will enable the insurance industry to better prepare itself for the upcoming changes under the IDD.

As the European Parliament and the European Council are not due to meet until March 1, 2018, it is intended that the delay will apply retroactively from February 23, 2018. This announcement provides comfort to member states, including the UK, who were intending to wait until the outcome of these proposals have been confirmed, before transposing the IDD into national law.

d. How is the UK Planning to Transpose the IDD?

Her Majesty’s Treasury (“HM Treasury”) is working with the PRA and the FCA to transpose the IDD into UK law.

i. HM Treasury

HM Treasury is responsible for the actual transposition of the IDD into UK law, which it is doing through the Insurance Distribution (Regulated Activities and Miscellaneous Amendments) Order 2018 (the “Order”). The Order will amend a number of pieces of existing legislation including various provisions in the Financial Services and Markets Act 2000. The latest draft of the Order was published on January 15, 2018 and includes amendments to reflect responses received from HM Treasury’s consultation on the proposed draft Order.

While a number of changes will be made to existing legislation, the UK legislative changes will not be as significant as the changes required in other member states, given that the UK “gold-plated” many of the provisions under IMD (such as (re)insurers already coming within the scope of IMD in the UK). That being said, as the IDD includes a number of requirements that were not included in IMD (such as cross-selling rules, enhanced professional training for distributors and their employees and the distribution of IBIPs), UK firms should review the consultation and draft Order to ensure that they will be compliant with the proposed new legislative framework.

The Order will be laid in Parliament “in due course,” however, the exact date of this is uncertain. Although, as a result European Council’s recent announcement that the transposition date for the IDD will be delayed until July 1, 2018, it is likely that the Order will come into force on or around this date.

ii. FCA and PRA

The FCA is making a number of changes to the FCA Handbook (the “Handbook”), which contains the rules and guidance that firms should abide by to ensure compliance with the IDD. The updated rules will be published in the FCA’s Insurance Distribution Directive Instrument 2018 (the “IDD Rules”). The FCA published three consultations on its proposed changes to the Handbook, which included drafts of the IDD Rules. In January 2018, the FCA published a near-final version of the IDD Rules and intends to publish the final IDD Rules once the Order has come into force. The FCA does not anticipate that there will be any changes to the recently published near-final IDD Rules.

Similarly to the proposed legislative changes, it is unlikely that the Handbook provisions will change drastically, as the Handbook already covers, to a greater or lesser extent, many of the requirements under the IDD. Indeed, some of the changes only amount to a change in the layout, to make the Handbook more user-friendly by having the distribution rules and guidance in one place. That being said, firms should familiarize themselves with the proposed Handbook changes to ensure that they will be compliant once they become applicable.

The PRA is only making minor, administrative changes to the PRA Rulebook, to reflect the implementation of the IDD.

e. Next Steps

Many firms, particularly smaller firms, will welcome the additional time to prepare for the application of the IDD. However, firms should still continue to push forward with their IDD preparations, to ensure they are fully compliant with the IDD ahead of its transposition and application.

In addition, even though the industry faces further uncertainty in light of Brexit, both HM Treasury and the FCA have advised that until the exit negotiations are concluded, all European legislation will continue to apply to UK firms. The outcome of the negotiations will determine what arrangements will apply in relation to EU legislation.
going forward, however, for the time being, firms should continue to prepare on the basis that the IDD will be transposed into national UK law prior to Brexit, and they will therefore be subject to its provisions.

4. SM&CR to be Extended to Insurers

On January 29, 2018, HM Treasury announced that the SM&CR, first introduced for banks in 2016, will be extended to include insurers from December 10, 2018. The UK government had previously legislated to extend the regime across all financial services firms and the extension into insurance is the first step towards this.

Insurers currently apply a revised version of the PRA’s SIMR and the FCA Approved Persons Regime. The regulators propose building on this framework and have issued a series of consultation papers in July and December 2017 setting out their proposals.

a. Scope of the SM&CR

The SM&CR will apply to all insurers (i.e., UK Solvency II firms, the Society of Lloyd’s, Lloyd’s managing agents, third country (re)insurance branches, ISPV and large non-Solvency II firms). A streamlined set of requirements will apply to small non-Solvency II firms.

There is a strong theme from both regulators that culture and governance are the main drivers behind the proposed extension of the regime. From the PRA’s perspective, a “key objective for the extension is to strengthen the PRA’s regulatory regime for insurers to ensure there is an effective governance system with a clear allocation of responsibilities within firms, as well as to ensure the individual accountability of senior managers and directors of insurers.”

Although the SIMR already incorporates some of the substantive ideas and principles of the SM&CR, there are some elements that will be new to insurers, as described below.

b. Duty of Responsibility

The establishment of a statutory “duty of responsibility” is an area that will affect senior managers and directors of insurers. Pursuant to changes made under legislation, the PRA will be empowered to take action for misconduct against an individual if:

- the individual has at any time performed as a “senior manager” at a firm;
- the firm contravenes, or has contravened, a regulatory requirement;
- at the relevant time, the senior manager was responsible for the management of any of the firm’s activities in relation to which the contravention occurred; and
- the senior manager did not take such steps as a person in his or her position could reasonably be expected to take to avoid the contravention occurring (or continuing).

The PRA consulted on what may constitute reasonable steps and what firms can do to document them. However, given that senior managers are already subject to conduct rules and are in a position which means they are responsible for managing and delegating effectively and appropriately, the new duty may not be as onerous on insurers as initially anticipated.

c. Certification Regime

The PRA is intending to specify certain “certification functions” that it considers to be “significant harm functions” (i.e., a function that could cause significant harm to the firm or its policyholders). The individuals performing these functions will need to be assessed as fit and proper by the firm and issued a certificate on this basis annually.

Certification functions do not include PRA or FCA controlled functions or non-executive directors, presumably since these individuals are already pre-approved by the regulators. Consequently, the PRA proposes that those individuals who should be designated as being in a certification function would be key function holders (“KFH”) given that these are individuals who are responsible for discharging a “key function.” In addition, “material risk takers” at “large firms” would also fall within scope (i.e., those employees whose professional activities have a material impact on the firm’s risk profile). As a minimum, the PRA would expect firms to consider individuals with responsibility for the following non-exhaustive list of functions as KFHs and therefore in a certification function: investment management; claims management; reinsurance; capital management; underwriting and pricing of products; and operational systems and control.

In terms of timing, firms will not be required to certify employees performing certification functions as fit and proper until 12 months after the commencement date of the SM&CR.

d. Conduct Rules

Under the current regime, individuals performing controlled functions, KFHs and any person performing a key function are required to adhere to certain conduct standards. The proposal is to extend the application of these rules to all employees who are holding a PRA “certification function” as well as those employees who are performing a controlled function on a temporary basis or who should have been approved for a controlled function. In broadening the scope of individuals to which the rules apply, the PRA wants to demonstrate the importance of conduct standards by individuals in key positions as well as enable it to take enforcement action against such individuals if material breaches occur. Firms will also be required to give these individuals suitable training to enable them to understand how the conduct rules apply to them. Senior managers and those individuals performing “certified functions” will need to be trained by the commencement date of the new regime. However, for other individuals, firms will have 12 months from the commencement date to provide the requisite training.

In addition, the PRA is proposing to introduce notification requirements for firms where they take disciplinary action against individuals for conduct rule breaches.

7 The PRA intends to define a “large firm” as a firm with annual premium income (gross of reinsurance) of more than £1 billion in each of the previous three financial years or with assets (including any reinsurance) related to regulatory activities of more than £10 billion at the end of each of the last three financial years.
e. Senior Managers Regime

More broadly, some of the terminology with which insurers are familiar under the SIMR will change to align with terms used by other regulated firms. For example, the record of the scope of responsibilities that is required to be maintained will be renamed “statement of responsibilities” and governance maps will be renamed “management responsibilities maps.” Separately, the PRA is also proposing to add a new rule with regard to the handover of responsibilities which will require firms to take all reasonable steps to ensure a senior manager is provided with all information reasonably expected in order to enable them to perform their new role effectively and in accordance with regulatory requirements.

f. Next Steps

The final rules are expected to be published this summer. However, firms will need to start preparing sooner rather than later as more individuals are brought into the scope of the new regime. This will require training for those individuals as well as updating policies and procedures ahead of the commencement date and a review and update of the current governance maps.

5. EU and Member State Competition Law Enforcement Activity

2017 was a period of increased enforcement activity by the Commission, the Court of Justice and the General Court (together, “EU Courts”), and by national competition authorities in the EU.

a. EU-Level Enforcement by the Commission and by the EU Courts

i. Commission

Following the expiry of the EU’s Insurance Block Exemption Regulation (“BER”) on March 31, 2017, insurers and reinsurers must now “self-assess” their compatibility with EU competition rules of arrangements that would otherwise have benefited from the safe harbor created by the BER. The Directorate-General for Competition (“DG Comp”) at the Commission has indicated in its 2017 Management Plan that the Commission’s General Horizontal Guidelines will apply to categories of cooperation previously covered by the BER.

In July 2017, the Commission published an inception impact assessment on the Motor Insurance Directive, in which the Commission confirmed that it has established an inter-service steering group, with the participation of DG Comp, to determine whether to extend the scope of compulsory liability insurance. The review focuses on: (a) information requirements to facilitate switching; (b) coverage of insolvency by guarantee funds; (c) coverage amounts for third-party liability policies; and (d) and the vehicle types and the places for which such policies are obligatory.

On July 4, 2017, the Commission carried out unannounced inspections at the premises of several automotive insurers in Ireland. In a statement released on the same day, the Commission alleged that the companies involved may have engaged in anti-competitive practices in breach of EU competition rules that prohibit cartels and restrictive business practices, or an abuse of a dominant market position. The Irish Competition Authority had previously issued witness summons and information requests concerning open statements concerning alleged price signaling in the sector.

In October 2017, the Commission initiated an investigation of alleged exchanges of commercially sensitive information by several broking firms in the aviation and aerospace insurance sector. At the same time, the FCA, which had reportedly carried out unannounced inspections at the offices of five such brokers in April 2017, appears to have closed its investigation. Such an informal transfer of an investigation to the Commission is unusual and may signal information exchange as a priority for the Commission after the expiry of the BER.

ii. EU Courts

Following a hearing on April 3, 2017, the General Court of the EU (“General Court”) delivered a judgment on February 5, 2018 which annulled a Commission decision regarding state subsidies to health insurers. The General Court held that insurers controlled by the Slovak Republic were undertakings for the purposes of EU competition law, and so subject to its rules, because of the presence on the market of private insurers. The fact that the state-owned insurers did not seek to make a profit, nor that all health insurers were precluded from setting prices for compulsory services, did not prevent insurers from competing, and so engaging in an economic activity.

On February 8, 2018, the Court of Justice of the EU (“CJEU”) delivered a preliminary ruling on public tenders by insurers. The case, which was referred by an Italian court, concerned the automatic exclusion of multiple tenders submitted by Lloyd’s of London syndicates in the same call for tenders, because they were allegedly under the common control of the Lloyd’s General Representative for Italy. The CJEU held that a national authority cannot exclude a tender without first affording each affected tenderer the opportunity to establish the independence of its tender.

On October 30, 2017, the Polish Supreme Court made a reference to the CJEU for a preliminary ruling regarding the fines imposed on a Warsaw-based insurer for its alleged abuse of a dominant position on the market for collective life insurance for employees. The judgment, which is expected in early 2019, will address the limitations imposed by EU competition rules on multiple fines ordered against a party in respect of one (and the same) act. The preliminary ruling could also provide guidance on the powers of multiple regulators to impose fines for the same conduct.

b. National Level Enforcement in the UK

In addition to enforcement activity at the EU level, there has also been significant enforcement activity at a national level, especially in the UK. Both the UK’s main competition authority, the Competition and Markets Authority (“CMA”), and one of its concurrent regulators, the FCA, undertook enforcement actions in the insurance sector in 2017.
i. CMA Review of the Undertakings Given by the National House Building Council

In March 2017, the CMA reviewed the undertakings on structural warranties previously given by the National House Building Council (“NHBC”). The CMA invited responses from affected parties, including home insurers, home builders, structural warranty providers, trade bodies, and consumers groups. The undertakings were revised and will remain in force for 15 years.

ii. CMA Digital Comparison Tools Market Study

On September 26, 2017, the CMA published the final report in its market study into digital comparison tools (“DCTs”), which concluded that DCTs improve competition by spurring lower prices, higher quality, innovation and efficiency. The government is expected to issue a full response to the CMA’s recommendations in spring 2018.

iii. CMA Investigation into Most Favored Nation Clauses Concerning Home Insurance Products

Based on evidence obtained in the market study into DCTs, in September 2017, the CMA launched an investigation into the use of “most favored nation” clauses by a price comparison website for home insurance products. The CMA’s provisional decision is expected in March 2018.

iv. CMA Market Investigation into Investment Consultancy and Fiduciary Management Services

In September 2017, following a reference from the FCA, the CMA launched a market investigation into investment consultancy and fiduciary management services. The CMA is expected to issue its provisional decision in July 2018, followed by the final report by March 13, 2019.

v. FCA Retirement Outcomes Review

In July 2017, the FCA published its interim report in the Retirement Outcomes Review, which identified limited customer switching and product innovation in pension and annuity products. The FCA consulted stakeholders in autumn 2017. The final report is anticipated in the second quarter of 2018.

The FCA has confirmed that it will require all firms offering guaranteed quotes on annuities to retail clients to provide certain information prompts as part of pre-sale disclosures, in a prescribed format, by March 1, 2018.

In April 2017, the HM Treasury unveiled a prototype of a pensions dashboard; the government’s objective is for the service to be available to consumers by 2019. The FCA also published a policy statement on implementing information prompts in the annuity market on May 26, 2017.

vi. FCA Non-Workplace Pensions Market Study

On February 2, 2018, the FCA published a Discussion Paper to gather views on the market for non-workplace pensions, in order to understand whether providers are competing on charges and whether any barriers inhibit consumers from identifying and choosing more competitive products. The FCA is seeking feedback by April 27, 2018.

vii. FCA Wholesale Insurance Brokers Market Study

In November 2017, the FCA launched a market study into the wholesale insurance broker sector, including the use of market power by brokers, the management of conflicts of interest, and the impacts on competition. Interested parties were invited to provide responses by January 19, 2018. An interim report is expected to be published in autumn 2018.

viii. FCA Aviation Insurance Investigations

In April 2017, the FCA opened an investigation into alleged exchanges of commercially sensitive information by aviation insurance brokers. The FCA is reported to have carried out unannounced inspections at the premises of Aon, Jardine Lloyd Thompson, Marsh, Willis Towers Watson and UIB. In October 2017, the Commission took over this investigation.

c. National Level Enforcement in Austria

In September 2017, Austria’s Bundeswettbewerbsbehörde (“BWB”) announced that the sector inquiry into the healthcare industry, halted in March 2016 due to funding shortages, recommenced in April 2017. The BWB had already identified potential vertical restrictions between hospitals and insurance companies. The inquiry is now expected to conclude in early 2018.

d. National Level Enforcement in Bulgaria

In June and July 2017, Bulgaria’s Commission for the Protection of Competition (“CPC”) sent statements of objections to six Bulgarian life insurance companies, which the CPC alleged had engaged in retail price maintenance in their agreements with insurance brokers. These companies included Allianz Bulgaria and the Bulstrad Vienna Insurance Group.

e. National Level Enforcement in Denmark

On June 12, 2017, the Danish Competition Council, the Konkurrenceradet, announced the launch a review of competition in the country’s pension market. The review covers collectively negotiated work-related pension schemes, which constitute the majority of plans, as well as private pension plans. The Konkurrenceradet will also consider recent pension reforms undertaken in Sweden.

f. National Level Enforcement in France

In its review of an acquisition of MédiPôle-Partenaires by Elsan, the French competition authority, the Autorité de la Concurrence (“Autorité”), consulted health insurers widely in order to evaluate the
competition risks of the proposed combination of the second- and third-largest operators of private hospitals in France. Initially referred to the Autorité by the Commission, the deal was ultimately cleared in June 2017, though subject to both structural and behavioral remedies.

g. **National Level Enforcement in Germany**  
On March 8, 2017, the German government's competition advisory body, the Monopolkommission, published a report which concluded that existing regulations restrict incentives for competition in the health insurance sector, and recommended reforms to the sector.

In November 2017, the German Federal Cartel Office, in its first use of new sector-specific investigative powers, launched a sector inquiry into online price comparison websites, including those active in insurance, hotels, and energy.

h. **National Level Enforcement in Hungary**  
In May 2017, the Hungarian Competition Authority, the Gazdasagi Versenyhivatal ("GVH"), finalized a market study into the domestic car retail, repair and related insurance services sectors. The GVH recommended that the government reintroduce measures to promote switching insurers.

In January, 2018, the GVH concluded an investigation, following a commitments decision, into alleged fixing of vehicle repair fees and conditional bonus payments for brokers who met certain insurance product sales targets, by Generali, Allianz and an insurance broker of Peugeot dealers.

i. **National Level Enforcement in Ireland**  
In July 2017, the Irish Competition and Consumer Protection Commission ("CCPC") conducted unannounced inspections, alongside officials of the Commission, at the premises of several automotive insurers. The CCPC had previously issued witness summons and information requests concerning open statements concerning alleged price signaling in the sector.

j. **National Level Enforcement in Italy**  
On August 9, 2017, the Italian competition authority, L'Autorità Garante della Concorrenza e del Mercato ("AGCM"), closed an in-depth investigation against twelve leading Italian insurance companies, including Unipol and Assicurazioni Generali, in the market for car liability insurance and associated guarantees.

Also in August 2017, the AGCM closed an investigation, following a commitments decision, into practices by the Italian agricultural consortium CODIPRA, which the AGCM considered to have abused a dominant position by engaging in exclusive dealing arrangements and by offering discounts for the use of insurance brokerage services supplied by its subsidiary, Agriduemila.

k. **National Level Enforcement in Latvia**  
In August 2017, the Latvian Competition Council commenced a review of the Latvian motor insurance market, following complaints regarding price increases in the sector.

l. **National Level Enforcement in Malta**  
In September 2017, the Malta Competition and Consumer Affairs Authority ("MCCAA") imposed interim measures against automotive insurers Atlas Insurance PCC, MAPFRE Middlesea, GasanMamo Insurance and Elmo Insurance, by which the MCCAA ordered the parties to bring to an end alleged exchanges of commercially sensitive information and discriminatory conduct. According to the MCCAA, the parties coordinated their conduct to apply less favorable payment terms to claims made in respect of repairs undertaken by garages which did not participate in the parties’ Quality Vehicle Repair Scheme, and distributed leaflets to disparage the same.

m. **National Level Enforcement in the Netherlands**  
On September 2017, Dutch Competition Authority, the Autoriteit Consument en Markt ("ACM"), published guidance on the tariffs which health insurers may publish without breaching competition rules. Under the safe harbor, insurers may publish hospital tariffs that fall under the insured’s “own risk,” as well as tariffs which are more than three years old.

Also in September 2017, the Court of Appeal of Arnhem-Leeuwarden published its judgment concerning an agreement between Coöperatie VGZ and certain of its suppliers, by which the latter's purchasing obligations constituted a restriction on parallel imports from other EU member states in breach of competition law.

On October 27, 2017, the ACM issued a notice to healthcare providers warning that it considered any collective boycott of insurance contracts in the sector to be a breach of competition law.

n. **National Level Enforcement in Portugal**  
In July 2017, Portugal’s Autoridade da Concorrência carried out unannounced inspections at the premises of four insurers located in Lisbon, and in January 2018 published a report detailing its competition policy priorities and identifying insurance as one of its priority sectors for enforcement in 2018.

o. **National Level Enforcement in Romania**  
In May 2017, the Romanian Competition Council ("RCC") concluded a sector inquiry into the medical services market, recommending several measures which it considered may improve competition. The RCC has also launched an investigation into medical services for which patients pay directly.

In September 2017, the RCC announced that it had carried out unannounced inspections, in relation to alleged market sharing agreements in the aviation insurance market, at the premises of Omniaasig Vienna Insurance Group, Generali Romania Asigurare Reasigurare, and Aon Romania Insurance-Reinsurance Broker. The CMA also assisted with requests for information in the UK.

p. **National Level Enforcement in Sweden**  
In April 2017, the Swedish Competition Authority, Konkurrensverket, opened an investigation into alleged anticompetitive agreements and coordination in the insurance sector. Following multiple unannounced
inspections between April and July, the Konkurrensverket announced in November that it was scrutinizing both public and private procurement contracts.

6. Impact of the EU’s GDPR on the Insurance and Reinsurance Industry

The GDPR entered into force in May 2016 and businesses, including (re)insurance companies, now have until May 25, 2018 to meet the new requirements under the GDPR. The GDPR aims to harmonize data protection legislation across the EEA, making compliance for (re)insurance companies that operate in multiple EEA jurisdictions easier.

However, in order to achieve this, the GDPR introduces a number of new requirements that will have a significant, and sometimes onerous, impact on (re)insurance companies. The GDPR is also likely to still be relevant to (re)insurance companies based in the UK despite Brexit, as the GDPR will become law in May 2018, which is before the UK withdraws from the EU in 2019, and even after withdrawal, the GDPR will continue to apply to UK companies that process data on individuals in the EEA. Some of the key provisions of the GDPR that are of particular relevance for the insurance and reinsurance industry are summarized below.

a. Greater Enforcement

The GDPR introduces an aggressive enforcement regime with administrative fines of up to 4% of a company’s annual worldwide turnover (gross revenue) or €20 million, whichever is the higher. In addition, Data Protection Authorities (“DPAs”) will also have significant investigative and corrective powers, such as the ability to impose a temporary or definitive ban on processing personal data, or to issue reprimands to controllers and processors for infringing the provisions of the GDPR. Further, any organization aiming to protect the data protection rights of individuals will be able to submit a complaint to a national DPA and bring actions on behalf of individuals. To reduce the risk of these sanctions being imposed, (re)insurance companies will need to carefully review the provisions of the GDPR and determine how they will ensure compliance.

b. Application to Non-European Businesses

The GDPR extends the territorial scope of data protection legislation to include data controllers and processors based outside the EEA that process personal data of individuals in the EEA, where the processing is related to:

1. the offering of goods or services to individuals in the EEA; or
2. the monitoring of their behavior. Therefore, if a U.S. or other non-EEA (re)insurer underwrites risk for or issues policies to companies or individuals in the EEA, or they monitor an insured’s behavior, they may come within the scope of the GDPR and if so, will need to comply with its provisions. This means that many international (re)insurance companies are likely to come within the scope of EEA legislation and therefore such organizations will now need to review their data processing policies and protections to ensure that they are GDPR compliant by May 25, 2018.

c. One-Stop-Shop

The GDPR introduces a new “one-stop-shop” mechanism where businesses carrying out “cross-border processing” will ordinarily be accountable to one single lead DPA in the EEA country where the data controller has its “main establishment.” The lead DPA is required to cooperate with all “concerned” DPAs to reach a consensus on any decision, and where no consensus can be reached, the case can be referred to the newly formed European Data Protection Board (“EDPB”) which will issue a binding opinion. In exceptional circumstances, a “concerned” DPA can adopt provisional measures and request an urgent opinion from the EDPB. This may be beneficial to (re)insurance companies that operate across the EEA, as they will only have to ordinarily report to and deal with one supervisory authority for data protection issues that affect their cross-border operations. The Article 29 Working Party published guidance to assist companies in determining the identity of their lead DPA in December 2016. The guidance states that where a company does not have an establishment in the EU (e.g., based in the United States), the one-stop-shop principle does not apply and the company must deal with DPAs in every EU member state in which it is active as well as appoint a data protection representative in one EU member state.

d. Data Controllers and Data Processors

The GDPR keeps the current distinction between “data controllers” and “data processors” under the Data Protection Directive. With respect to the (re)insurance industry, it is likely that (re)insurance companies will be treated as data controllers. This is on the basis that, for example, (re)insurance companies, in many circumstances, determine what data of their customers and employees is to be collected, and for what purposes this data is to be used for. As a result of being classified as a data controller (relative to being classified as data processor), (re)insurance companies become responsible for complying with the majority of the obligations under the GDPR. (Re)insurance companies often use many vendors and the GDPR substantially broadens the obligations that must be contractually imposed on processors by controllers. Therefore, it is likely that many contracts that (re)insurance companies have entered into will continue past May 2018, and will need to reflect these enhanced requirements.

In addition, the GDPR introduces the concept of joint and several liability for controllers and processors, meaning that individuals can claim for compensation from either the controller or processor in the event of non-compliance with relevant GDPR requirements. Therefore, documenting how liability will be apportioned in these events will now be extremely important, and contracts between controllers and processors will need to take this into account, as well as mechanisms to resolve any disputes.
e. Notice and Consent

The GDPR has increased the thresholds for obtaining valid consent to process personal data, and consent must now be freely given, informed, clear and affirmative, rather than implicit and tacit. (Re)insurance companies should therefore consider, where possible, relying on an alternative legal ground such as legitimate interest where data is not sensitive or where necessary for reasons of substantial public interest. Where consent is the only valid legal ground, data controllers will also need to be able to prove that they have received such consent from an individual for each processing operation they undertake. This could be problematic for (re)insurance companies, as (re)insurance companies often do not have a direct interaction with the insureds, instead receiving the information through a broker, a MGA or a cedent insurer. As such, (re)insurance companies will likely need to rely on such third parties having obtained valid consent and adequate information sufficient so as to enable the (re)insurance company to process the personal data for its necessary purposes. (Re)insurance companies will therefore need to re-visit their contracts with intermediaries and consider imposing such obligations via contract. In addition, the GDPR sets out new requirements as to the information that should be provided in data privacy notices, including, for example, the contact details of the data controller, the legal basis of processing and the data retention period.

As a result of these increased requirements, (re)insurance companies will need to update and amend their policies, and customer materials to ensure they provide the correct information in data privacy notices. In the UK, the Lloyd’s Market Association has published its Core Uses Information Notice, designed to help individuals understand how various insurance market participants process their personal data through the insurance lifecycle and which can be cross-referred to in the notices of (re)insurance companies.

f. Accountability

The GDPR sets out enhanced accountability principles, including the requirement for organizations to implement data protection policies, to maintain a detailed record of processing activities, to conduct privacy impact assessments and to implement data protection by “design” and “default.” An organization will be required to conduct a privacy impact assessment where data processing uses new technologies and is likely to result in a “high risk” for individuals.

Evaluating personal data based on automatic processing (such as profiling), processing sensitive personal data on a large scale or systematically monitoring a publically accessible area on a large scale are all examples of when a privacy impact assessment would be required. In addition, consultation with the DPA may also be required, where processing would result in a high risk. As much of the personal data held by (re)insurance companies would be considered sensitive personal data (as (re)insurance companies in particular, those in the life and motor industries, often need information regarding health prior to issuing a policy) and profiling is used in certain insurance functions (such as underwriting), it is likely that many (re)insurance companies will be required to carry out a privacy impact assessment. These requirements add an additional compliance step for (re)insurance companies, which will need to be budgeted for in cost and time.

g. Information Security and Breach Notification

All organizations must implement appropriate technical and organizational security measures, particularly if sensitive personal data is processed (e.g., health data, or racial or ethnic origin data). Furthermore, after becoming aware of a security breach, depending on the level of risk, data controllers will be required to notify both their national DPA and the individuals adversely affected by the security breach, without undue delay and, where feasible, not later than 72 hours after the data controller becomes aware of the security breach. Given that insurance companies, particularly life insurance companies, process a considerable amount of sensitive personal data about individuals, such organizations are an attractive target for hackers. Therefore, insurance companies should define and document a security breach response plan and update their IT-systems to ensure they have adequate safeguards in place to protect against potential cyber attacks. The GDPR introduces a definition of pseudonymization, which was undefined in previous legislation.

Pseudonymization (e.g., the processing of personal data in a way that can no longer be attributed to an individual without the use of further information) is now a formally recognized security technique, and (re)insurance companies that do not already use this technique may wish to consider whether to introduce it. Nonetheless, pseudonymized data is regarded as “personal data” and will be subject to the GDPR.

h. Increased Rights of Individuals

Two of the more controversial rights introduced under the GDPR include the “right to be forgotten” (or the “right to erasure”) and the “right to data portability.” The “right to be forgotten” allows individuals (including children) to ask for their personal data to be deleted in certain circumstances, such as when the processing is no longer necessary or the individual withdraws consent. Data controllers and processors must comply with such requests unless certain derogations apply. In addition, where a controller is required to erase personal data which it has made public, the controller must take reasonable steps to inform other controllers (e.g., intermediaries and cedent insurers) that are processing such personal data that the individual has requested the erasure by such controller of any links to, or copies or replications of, such personal data. (Re)insurance companies will need to carefully assess this new right to be forgotten and determine how they will deal with requests to be forgotten, and when the derogations to this right can be relied upon. (Re)insurance companies may need to keep personal data to comply with legal or regulatory obligations, or to be able to pay out on a policy at a later stage. However, whether such legal or regulatory obligations will come under one of the derogations is still uncertain and (re)insurance companies should therefore keep an eye on how this right will be exercised in practice and ensure that frontline staff are equipped to deal with these requests appropriately.

The “right to data portability” allows individuals to request copies of their personal data from data controllers or processors (when the controller or processor is processing based on consent or performance of a contract), so that they can transfer their data to another provider. To facilitate the operability of this right, controllers
should ensure that personal data is processed in a machine-readable, structured and commonly-used format, where this is technically feasible. In guidance recently published by the Article 29 Working Party, it states that there should be a focus on “interoperable” systems where controllers should provide as many metadata with the data as possible at the best possible level of granularity, to reserve the precise meaning of exchanged information. This could be problematic for insurers and their intermediaries, as many hold personal data on different systems depending on the stage at which the data is processed. For example, they might have a separate system for underwriting or a separate system for dealing with claims. Also, given the nature of insurance policies and how long they might be in issue for, many insurance companies may store personal data on older systems that might not be compatible with newer systems, making interoperability difficult. Accordingly, this right could expose insurance companies to large administrative burdens, as they would need to update and amend their processing systems to ensure they are standardized and interoperable. Development of interoperable formats to enable data portability is actively encouraged in the GDPR and the guidance published by the Article 29 Working Party, and therefore, in order to mitigate the impact of this new right, the (re)insurance industry should start developing strategies to determine how they will deal with it.

i. Profiling

The GDPR introduces new restrictions on data controllers carrying out profiling. Profiling is any form of automated processing of personal data consisting of the use of personal data to evaluate certain personal aspects relating to a natural person, in particular to analyze or predict aspects concerning that natural person’s performance at work, economic situation, health, personal preferences, interests, reliability, behavior, location or movements. Data subjects now have a right not be subject to a decision based solely on automated processing (including profiling), which produces legal effects on, or significantly affects an individual; unless the profiling (a) is necessary for the performance of a contract; (b) has been authorized by member state law; or (c) is conducted with the explicit consent of the individual, and appropriate safeguards are implemented (profiling and automated decision-making cannot be applied to children).

This restriction could potentially extend to virtually all forms of data analytics including positive forms of profiling. This right will have a huge impact on the (re)insurance industry, as the underwriting process uses platforms that are designed to price risk, allocate premiums automatically and systematically process information about individuals. In addition, the (re)insurance industry uses big data projects to assist in market analysis, targeted marketing and fraud detection, all forms of automatic processing. The new restriction on profiling is likely to add additional burdens for (re)insurers that undertake these types of processing activities and in light of this, (re)insurers should review their current profiling activities to ensure compliance with the GDPR.

j. Transfer of Personal Data from the EEA

The GDPR maintains the current restriction on transferring personal data to countries outside the EEA that are not considered to have an adequate level of protection, such as the United States. It also retains existing data transfer solutions, such as EU standard data protection clauses (also referred to as model contracts), the use of Binding Corporate Rules and the recently adopted EU-U.S. Privacy Shield.

k. Final Thoughts

It is clear that the GDPR will significantly impact the way in which the insurance industry processes personal data. While harmonization of data protection across the EEA will reduce the cost of the administrative burden that results from legal fragmentation, some of the key changes will require insurance companies to make policy or other administrative changes, which will be costly in the short term. It is important for the insurance industry to understand their obligations under the GDPR and start making the requisite policy, procedural, technological or other changes to ensure compliance. Failure to do so could result in significant sanctions and liabilities.

V. Cyber Risk

A. U.S. CYBER RISK DEVELOPMENTS

Cyber risk is one of the most serious global risks, and “cybersecurity” is a top priority of both private companies and government entities, including state insurance departments. Cybersecurity generally focuses on the protection of computers, networks, programs and data from unintended or unauthorized access or destruction. In the insurance context, cybersecurity is particularly focused on safeguarding insurance consumers’ personal information, which often contains Social Security numbers, financial information and medical information.

Over the last several years, regulators have undertaken significant efforts to require the insurance sector to implement improved cybersecurity measures. Highlighted below are recent regulatory developments in the insurance sector concerning cybersecurity. These developments have encouraged insurance companies (like all financial services providers) to review and refine their information security practices and corporate governance protocols related to cybersecurity to meet the rising regulatory and compliance demands in the insurance and financial services sector.

1. NAIC Activity

a. Adoption of the Insurance Data Security Model Law

After over two years of work drafting and responding to comments from interested parties, the NAIC adopted the Insurance Data Security Model Law (the “IDS Model Law”) on October 24, 2017. During the time that the NAIC was developing the IDS Model Law, the NYDFS promulgated its own cybersecurity regulation, “Cybersecurity Requirements for Financial Services Companies” (the “NY Cybersecurity Regulation”), in February 2017 (see Section IV.A.2.a below). The IDS Model Law development process was influenced significantly by the NY Cybersecurity Regulation, and as a result, the IDS Model Law, as adopted by the NAIC, is similar to the NYDFS Cybersecurity Regulation in structure and substance.
Some differences between the IDS Model Law and the NY Cybersecurity Regulation include the following:

- while the IDS Model Law requires “due diligence” when selecting third-party service providers and the adoption of appropriate security measures, it does not include the NY Cybersecurity Regulation’s specific requirements for extensive written policies and procedures relating thereto;
- the IDS Model Law requires that a cybersecurity program be “commensurate with the size and complexity” of a licensee, whereas the NY Cybersecurity Regulation is more prescriptive regarding the criteria that may be required to ensure compliance (e.g., encryption, multi-factor authorization, access controls, audit trails and penetration testing/monitoring);
- whereas the NY Cybersecurity Regulation requires notice to the state insurance department of any attempt to breach a licensee’s systems (whether or not successful), the IDS Model Law only requires notice when unauthorized access has occurred; and
- unlike the NY Cybersecurity Regulation, the IDS Model Law includes an exemption for entities that have complied with data security requirements under the Health Insurance Portability and Accountability Act of 1996 (HIPAA).

b. Formation of Innovation and Technology (EX) Task Force

Technology-related developments, products and services in the insurance industry are often evaluated by regulators to determine whether additional consumer protections related to such developments are required. With the boom of the insurtech sector, the NAIC has increased its focus on such issues. Specifically, the NAIC formed a new task force, the Innovation and Technology (EX) Task Force (the “IT Task Force”), to monitor technology, data collection and cybersecurity developments in the insurance industry.

The IT Task Force, which reports directly to the NAIC’s Executive Committee, was charged with the oversight of the following NAIC groups: the Cybersecurity (EX) Working Group, the Speed-to-Market (EX) Working Group and the Big Data (EX) Working Group. The Cybersecurity Working Group developed the IDS Model Law (see Section IV.B.7 above). The Speed-to-Market Working Group oversees the modernization of insurance product filings and reviews, monitors the System for Electronic Rate and Form Filing (SERFF) and provides support to the Interstate Insurance Product Regulation Commission for initiatives requiring uniformity and policy changes within the states. The Big Data Working Group addresses insurance industry collection and use of consumer and other data (see Section IV.B.7 above).

2. Individual State Initiatives

a. Implementation of the NY Cybersecurity Regulation

August 28, 2017 was the first compliance due date under the NY Cybersecurity Regulation, which was adopted on February 16, 2017. By August 28, 2017, all entities covered by the NY Cybersecurity Regulation (“Covered Entities”) were required to: (i) have a cybersecurity program in place, as well as a written cybersecurity policy approved by the Covered Entity’s board or a senior officer, (ii) appoint a Chief Information Security Officer to help protect data and systems, (iii) implement various controls and plans to ensure the safety of information and (iv) report cybersecurity events to the NYDFS through the Department’s online cybersecurity portal.

By February 15, 2018, Covered Entities must comply with additional obligations under the NY Cybersecurity Regulation, including: (1) adopting a formal written cybersecurity program, (2) limiting/restricting access privileges to information systems that provide access to nonpublic information, (3) having cybersecurity personnel (internally or through qualified third-party providers), (4) designating a chief information security officer, (5) having a written incident response plan and (6) filing a certificate of compliance with the NYDFS.

Compliance with additional obligations under the NY Cybersecurity Regulation will be required effective March 1, 2018 (e.g., annual reports from the chief information security officer to key stakeholders, annual penetration testing, bi-annual vulnerability assessments and training of personnel) and September 2018 (e.g., policies for retention and disposal of nonpublic information, audit trails to detect security incidents and reconstruct financial data, monitoring of authorized user activity and encryption or other controls to protect data in transit and at rest).

b. New York Circular Letters Regarding Disaster Recovery Plan Obligations

On March 28, 2017, the NYDFS published two Circular Letters requiring advance planning by the insurance industry for disasters, including storms, terrorist attacks and cybersecurity breaches. The two Circular Letters are NYDFS Insurance Circular Letter No. 4, “Disaster Planning, Preparedness, and Response by the Property/Casualty Industry” (the “P&C Circular Letter”), and NYDFS Insurance Circular Letter No. 5, “Disaster Planning, Preparedness, and Response by the Life and Health Insurance Industries” (the “L&H Circular Letter”) and together with the P&C Circular Letter, the “Circular Letters”). The P&C Circular Letter is directed to all property-casualty insurers authorized to write business in New York (including reciprocal insurers, captive insurers and mortgage guaranty insurers) as well as insurance-related organizations such as the Excess Line Association of New York and rate service organizations (collectively, the “P&C Addressees”). The L&H Circular Letter is directed to all life insurance companies, retirement systems, fraternal benefit societies, employee welfare funds, accident and health insurance companies, non-profit medical and dental indemnity, or health and hospital service corporations, health maintenance organizations, and municipal cooperative health benefit plans, in
each case authorized to write business in New York (collectively, the “L&H Addressees” and together with the P&C Addressees, the “Addressees”).

Among other things, the Circular Letters:

- outline the NYDFS’s expectations with respect to insurers preparing for and responding to disasters affecting New York residents;
- set forth requirements for business continuity plans and disaster response plans that are filed with the NYDFS; and
- require the completion of business continuity and disaster response plan questionnaires and completion by certain property-casualty insurers of a pre-disaster survey.

With respect to business continuity and disaster response plans, all Addressees must regularly perform a “business impact analysis” in order to predict the consequences of disruptions in business functions and processes caused by disasters and to develop recovery strategies. Such analysis should be used to establish and update business continuity plans filed with the NYDFS.

Additionally, all Addressees (other than the Excess Line Association of New York, rate service organizations, financial and mortgage guaranty insurers and title insurers) must perform a risk-based analysis of their ability to assist policyholders, claimants and other parties affected by a disaster. The results should be used for establishing and updating disaster response plans.

Under certain circumstances, the Circular Letters provide that entities that are covered under certain of their affiliates’ business continuity and disaster response plans and are able to demonstrate to the NYDFS the adequacy of such plans do not need to establish their own plans.

B. UK AND EUROPE

1. Regulatory Focus on Cyber Risk

Cyber risk continues to come under sharp focus from the UK regulators given the increase in the number and severity of cyber attacks. For a UK insurer, compliance with regulation comprises not only a review of a firm’s own cyber underwriting risk, but also, as a financial services firm holding valuable data, ensuring that it maintains effective cyber security.

   a. PRA Supervisory Statement

   In July 2017, the PRA issued a supervisory statement (SS4/17) setting out its expectations for the management of cyber insurance underwriting risk. Cyber underwriting risk is defined in the statement as “the set of prudential risks emanating from underwriting insurance contracts that are exposed to cyber-related losses resulting from malicious acts (e.g., cyber attack, infection of an IT system with malicious code) and non-malicious acts (e.g., loss of data, accidental acts or omissions) involving both tangible and intangible assets.”

   The statement applies to all UK non-life (re)insurance firms and groups within the scope of Solvency II as well as the Society of Lloyd’s and managing agents (collectively, “Solvency II firms”).

The supervisory statement is the result of a thematic review between October 2015 and June 2016 with a variety of stakeholders (including (re)insurers, cyber security and technology firms and catastrophe modelling vendors), where a number of potential issues facing the insurance industry came to the fore.

The purpose of the statement is to set out the PRA’s expectations for firms which, in summary, are that firms should be able to “identify, quantify and manage cyber underwriting risk” both with respect to risks arising from affirmative cyber insurance policies, such as data breach products, and also in respect of non-affirmative cyber risk (i.e., insurance policies that do not specifically include or exclude coverage for cyber risk). The latter type is sometimes referred to as “silent” cyber risk.

   b. Non-Affirmative Cyber Risk

   In order to reduce the exposure to non-affirmative cyber risk, the PRA expects Solvency II firms to “robustly assess and actively manage their insurance products,” paying particular regard to this kind of exposure and to introduce measures to reduce unintended exposure in order to align the residual risk with the risk appetite and strategy agreed by the Board. One method of reducing this risk would be to set aside a capital provision, for example. Alternatively, the PRA suggests other non-exhaustive measures firms could introduce, such as:

   - offering explicit cover and adjusting the premium to reflect the actual risk;
   - inserting wording exclusions;
   - setting specific limits of cover; and
   - clarifying policy wording as to whether cyber cover is included in the particular product.

   c. Cyber Risk Strategy and Risk Appetite

   The PRA expects firms to have clear strategies in managing the risks arising where firms write affirmative cyber cover and/or where they are exposed to non-affirmative cyber risk. The PRA is clear that any such strategies must be owned by the Board and should include both a quantitative and qualitative focus, for example establishing rules for line sizes and aggregate limits. The PRA expects the strategy and overall exposure levels of non-affirmative cyber risk to be reviewed by the Board on at least an annual basis. The review should be carried out more regularly for affirmative cyber risk.

   d. Cyber Expertise

   The PRA recognizes that firms in the cyber risk space require an investment in expertise in this field and therefore expects firms that are materially exposed to this risk to continue to develop their knowledge, especially since it is an area that is constantly evolving.

   The PRA also expects that this knowledge should be fully aligned with the associated level of risk and growth targets and should cover all three lines of defense: business, risk management and audit.
Although it is likely that external advice in relation to cyber risk will be obtained, the PRA is keen to emphasize that firms are still ultimately responsible for the management of these risks with the Board having appropriate oversight of the controls in this area.

The PRA’s starting position, following its discussions with the thematic review participants, is that cyber risk is always material. This is on the basis of the “endemic nature of non-affirmative cyber risk to potentially all P&C insurance contracts” and/or the rapid growth in affirmative cyber insurance.

e. FCA Guide to Good Cyber Security

Whilst the PRA’s focus is on firms managing their cyber underwriting risk, the FCA goal is to help firms themselves to become more resilient to cyber attacks. In accordance with Principle 11 of the FCA Handbook, firms are required to report material cyber incidents. An incident may be material if it:

- results in significant loss of data or the availability or control of a firm’s IT systems;
- affects a large number of customers;
- results in unauthorized access to, or malicious software present on, your information or communication systems.

In June 2017, the FCA published a guide for firms on the foundations for good cyber security. These are common sense principles that firms should adhere to in order to make themselves less vulnerable to a cyber incident. The following is considered effective cyber security practice by the FCA:

- **Managing the risk.** Firms should know what information they hold and why, as well as knowing who has access to its most sensitive data.
- **Encryption.** Encryption software should be used to protect critical information from unauthorized access.
- **Disaster recovery.** Critical systems and data should be backed up, and these processes should be tested regularly.
- **Network and computer security.** Systems and software should be kept up-to-date and fully patched.
- **User and device credentials.** Employees should use strong passwords.
- **Awareness.** Staff should be educated on cyber security risks.
- **Accreditation.** Gaining a recognized accreditation and aligning the firm to a recognized cyber scheme could improve its security.
- **Information sharing.** Sharing threat information with peers is recognized to be beneficial in strengthening a firm’s cyber defenses.

In a speech given by the FCA in April 2017 on the threat landscape, it was highlighted that many firms believed that they were getting the basics right as far as cyber security was concerned, but that this was not reflected in reality. The FCA noted that in a 2016 Verizon data breach investigations report (which provides an analysis of 2,260 data breaches and 64,199 security incidents from 61 countries), 10 vulnerabilities accounted for 85% of successful breaches. A significant number of the vulnerabilities were well known and had fixes available at the time of the attack, but were not implemented by firms either at all or properly.

f. What Responsibilities do Firms Have?

The PRA’s initial review revealed that most firms do not have the appropriate tools to “monitor, manage and mitigate” cyber underwriting risk. As a corollary, policyholders with traditional property and casualty policies may not have contract certainty as to whether or not cyber risk falls within the cover. The FCA is separately concerned that insurers practice good cyber security.

Insurers’ responsibilities are therefore twofold. On the one hand, they must ensure that they are fully cognizant of the risks they are underwriting in relation to cyber and cater for such risks appropriately. On the other hand, insurers are themselves potential targets of a cyber attack and need to ensure that they adhere to cyber security measures that will protect their data. This will become even more of a priority when the GDPR comes into force in May this year.

VI. Select Tax Issues Affecting Insurance Companies and Products

A. U.S. TAX REFORM LEGISLATION

The most significant tax development this year was the passage of the TCJA. Although popularly described as “fundamental tax reform,” the taxation of domestic business enterprises remains fundamentally the same. The international tax system, on the other hand, was fundamentally reworked. While a full discussion of the TCJA is beyond the scope of this review, some of the most significant changes in the domestic context are noted below:

- The corporate tax rate was reduced from 35% to 21%, and the corporate alternative minimum tax was repealed;
- Immediate 100% expensing for certain expenditures until 2023;
- New limits on the deductibility of interest under Internal Revenue Code Section 163(j);
- Use of net operating losses (“NOLs”) subject to limit of 80% of pre-NOL taxable income. The carryback of NOLs was eliminated, but NOLs now carry forward indefinitely.

Certain elements remain unchanged; however:

- The classic entity level tax on corporate earnings remains intact, and U.S.-taxable shareholders are taxed a second time when profits are returned in the form of dividends;
- The consolidated return rules remain intact;
- The rules regarding tax-free reorganizations and tax-free spin-offs are unchanged; and
• The controlled foreign corporation (“CFC”) and PFIC regimes remain in place (with some significant changes in application).

The changes to the international tax system were much more significant. Among the highlights:

• A new “participation exemption”, providing for a 100% deduction for U.S. corporations for dividends paid by at least 10% owned foreign corporations. To transition to such a territorial system, the TCJA imposes a one-time transition tax through a deemed repatriation of all accumulated foreign earnings of certain foreign subsidiaries.

• A new “carrot-and-stick” approach providing for (i) preferential rates on foreign-derived intangible income earned by U.S. corporations, but (ii) current inclusion for 10% owners of foreign corporations with global intangible low-taxed income (“GILTI”). U.S. corporations are entitled to preferential rates on GILTI.

• A new 10% minimum tax on U.S. corporations known as the base erosion and anti-abuse tax (“BEAT”). This provision is aimed at U.S. corporations that reduce the U.S. tax base through deductible payments to affiliates.

In addition to these general provisions, the TCJA contained a number of special provisions with special consequence for the U.S. insurance industry. While insurance companies will benefit from the reduced corporate tax rate, many of the insurance specific provisions have the effect of accelerating taxable income in order to help Congress satisfy revenue needs within the ten-year budget window 2018-2027. These targeted increases, and other tax reform provisions affecting insurance, are described below.

1. Life Insurance Company Reserves

Under the TCJA, tax reserves for life insurance companies are generally equal to the greater of net surrender value (if any) or 92.81% of the Commissioners’ Reserve Valuation Method (“CRVM”) or Commissioners’ Annuity Reserve Valuation Method (“CARVM”) reserve for the contract, subject to a cap equal to statutory reserves actually held. The prior law concept of the federally prescribed reserve is repealed. CRVM or CARVM means the CRVM or CARVM in effect as of the date the reserve is determined. The controversial prior law concept of the CRVM or CARVM “in effect on the issue date” is eliminated.

Tax reserves must be restated as of January 1, 2018, and an eight-year spread period is provided for taking the resulting reductions into taxable income. If the restatement produces an increase in the reserve for a contract, the increase is treated similarly, as a deduction spread over an eight-year period.

2. DAC Tax

Under the TCJA, insurance companies with premium income from certain categories of business must capitalize more of their otherwise deductible business expenses, and the amortization period for the capitalized amounts is longer, than under prior law. The capitalization rates are increased from 1.75% of premium to 2.09% for annuity business, from 2.05% to 2.45% for group life, and from 7.7% to 9.2% for other specified contracts (e.g., individual life business). The amortization period is extended from 10 years to 15 years. Existing DAC balances from pre-2018 years continue to be amortized on their existing schedule.

The TCJA’s targeted provisions on DAC and life insurance company reserves are officially estimated to generate a combined US$22.4 billion of tax revenue in the ten-year budget window 2018 through 2027.

3. Life Insurance Company “Proration”

Insurance companies that earn certain tax-favored investment income are deemed to use part of it to fund tax-deductible reserves and benefits for policyholders. Provisions commonly referred to as the “proration” rules require insurance companies to reduce tax benefits accordingly. The principal tax benefits affected are the dividends-received deduction (“DRD”) and the exclusion of interest on municipal bonds.

Under prior law, companies holding dividend-paying stocks in separate accounts for variable life and annuity products reduced the related DRD under complex formulas determining the “company share” and “policyholder share.” The TCJA eliminates variation and complexity by establishing a uniform “company share” of 70%.

Observers have noted that the 70% “company share” might make general account investments in municipal bonds more attractive for life companies.

4. P&C Company “Proration”

P&C insurance companies are subject to a simpler rule which, under prior law, required them to reduce losses incurred by 15% of certain tax-favored investment income (e.g., interest on municipal bonds). The effective tax rate on this income was 5.25% under the prior law 35% corporate tax rate.

The TCJA increases the proration percentage from 15% to 25% to maintain the same effective tax rate of 5.25% in light of the new 21% corporate income tax rate.

5. P&C Loss Reserve Discounting

Compared with prior law, the TCJA requires P&C insurance companies to discount their unpaid losses for tax purposes using a higher interest rate (derived from a corporate bond yield curve) and, for certain lines of business, a longer assumed loss payment pattern.

Loss reserves as of December 31, 2017 are restated under the new discounting rules, and the amount of the resulting reduction is taken into income over eight taxable years.

This provision of the TCJA is officially estimated to generate US$13.2 billion of tax revenue in the ten-year budget window 2018 through 2027.
6. NOLs
For losses arising in tax years beginning after 2017, the TCJA repeals carryback provisions for life insurance companies, as it does for non-life insurance companies, and makes the carryover period indefinite (no expiration). However, such loss carryovers may be used to eliminate only 80% of pre-NOL taxable income in any year.

P&C insurance companies retain the existing “2-and-20” carryback and carryover periods without the 80% limitation described above. In this respect, the TCJA recognizes that the existing NOL rules have special importance to the P&C industry in light of volatility due largely to natural disasters.

7. Base Erosion Anti-Abuse Tax
The TCJA imposes a new corporate “base erosion” minimum tax at a 10% tax rate on “modified taxable income” (“MTI”). MTI is taxable income determined without taking into account “base erosion tax benefits” from “base erosion payments” to related foreign persons. The provision applies to groups with at least US$500 million of average annual gross receipts and a “base erosion percentage” of at least 3%. No change is made to the federal excise tax on insurance.

The base erosion minimum tax is phased in at a 5% rate for 2018, 10% for 2019 through 2025, and scheduled to increase to 12.5% beginning in 2026. For groups that include a bank or securities dealer, the rates are one percentage point higher and the “base erosion percentage” threshold is lower, 2%.

Uncertain aspects of the provision include:

1. The lack of an exception for foreign affiliates engaged in a U.S. business (e.g., through a U.S. branch).
2. Treatment of offsetting/related payments from foreign affiliates. Should the addback to taxable income be the gross reinsurance premium or only the net profit on the ceded business (i.e., the true amount of “base erosion”)?
3. Loss and claim reimbursements paid or incurred to related foreign companies that purchased coverage from a U.S. affiliate.
4. Application of the rule to modified coinsurance arrangements.
5. Determination of the base erosion minimum tax on a consolidated basis for affiliated groups.
6. MTI NOL carrybacks/carryovers.

8. CFCs – Downward Attribution
Prior to the TCJA, Code Section 958(b)(4) prohibited so-called “downward attribution” of stock ownership from a foreign person to a U.S. person (e.g., a U.S. corporation or U.S. partnership) in which the foreign person owns an equity interest. The provision significantly expands the circumstances in which a foreign corporation will be classified as a CFC. For example, foreign corporations that are subsidiaries in a foreign-parented group will in many cases be CFCs if the group includes any U.S. subsidiaries, due to the downward attribution of the foreign subsidiaries’ stock to the U.S. subsidiaries.

This could result in annual inclusions of subpart F income for other U.S. persons that directly or indirectly own a stake in the CFC if their total direct, indirect, and constructive ownership is 10% or greater. The Senate explanation, restated in the conference report, indicates that this result is not intended to apply where such U.S. person, and the U.S. entity to which stock is attributed downward from a foreign person, are not “related” to one another, but the text of the TCJA does not include any language to implement such intention. The provision is generally effective retroactively beginning with the 2017 tax year.

9. CFCs – 10% Shareholder by Value
Prior to amendment by the TCJA, for subpart F purposes, a “United States shareholder” was generally defined as a U.S. person that owns (directly, indirectly or constructively) 10% or more of the voting power of the stock of a foreign corporation.

The TCJA expands the definition of “United States shareholder” to include a U.S. person that owns (directly, indirectly or constructively) 10% or more of the value of the stock of a foreign corporation.

The provision would therefore render obsolete common planning techniques used to avoid subpart F income inclusions by limiting the voting power (but not the value) of the stock of a foreign corporation owned by a U.S. person (e.g., voting power cutbacks, use of nonvoting stock). The provision is generally effective beginning with the 2018 tax year.

10. PFICs
A foreign corporation that owns predominantly financial assets such as securities is generally treated as owning “passive” assets that produce “passive” income, making the corporation a PFIC. Under prior law, a foreign corporation would not be treated as a PFIC if it derived income from its financial assets “in the active conduct of an insurance business,” was “predominantly engaged in an insurance business,” and would qualify to be taxed as an insurance company if it were domestic. Little guidance was available regarding the application of this active insurance exception. Regulations were proposed but left open crucial questions as to the proper application of these standards.

The TCJA revises the insurance exception to add the concept of a “qualifying insurance corporation,” defined as a corporation that would qualify to be taxed as an insurance company if it were domestic and which has “applicable insurance liabilities” greater than 25% of its total assets. Qualifying insurance corporation status may also be available to a company that does not meet this threshold under certain circumstances.

Under the TCJA “applicable insurance liabilities” include unpaid losses and loss adjustment expenses and certain reserves for life and
health insurance risks. The conference report indicates that annuity reserves are intended to be applicable insurance liabilities. Unearned premium reserves are not applicable insurance liabilities.

This revised exception should provide somewhat greater certainty than current law, but uncertainty will remain because the revised exception still requires “the active conduct of an insurance business.”

11. Taxable Year of Income Inclusion

The TCJA provides that accrual method taxpayers must take income into account no later than when the item of income is taken into account in an “applicable financial statement.” The rule does not apply to “any item of gross income for which the taxpayer uses a special method of accounting” under a provision other than Code Sections 1271-1288 (relating to original issue discount and market discount).

An “applicable financial statement” means a financial statement prepared in accordance with GAAP, IFRS, or, if neither is applicable, a financial statement specified by the Treasury Department.

The conference agreement clarifies that this provision is not intended to require a taxpayer to recognize income when a realization event has not occurred. For example, a taxpayer will not need to recognize gain or loss solely as a result of marking securities to market for financial reporting purposes.

The scope of this provision remains unclear. The timing rules of subchapter L relating to premiums, as well as the nonaccrual of market discount for life companies under Code Section 811(b)(3), would appear to be special methods of accounting applied under provisions other than Code Sections 1271-1288. Provisions of subchapter L indicating that tax treatment generally conforms to statutory accounting may arguably constitute a special method of accounting; otherwise this new provision of the TCJA could arguably give GAAP financial statements a higher priority than statutory financial statements for certain items of income.

The provision is generally effective for taxable years beginning after December 31, 2017. However, the provision will not apply to income from a debt instrument having original issue discount until taxable years beginning after December 31, 2018.

B. INTERNATIONAL TAX ISSUES

In 2013, responding to concerns by some policymakers that multinational enterprises (“MNEs”) were able to unfairly reduce their net worldwide income tax through legal tax planning techniques that shift the recognition of income from high-tax jurisdictions to low-tax ones (such practice, “base erosion and profit shifting,” or “BEPS”), the Organisation for Economic Co-operation and Development (the “OECD”) commenced a study of mechanisms that would combat BEPS. That year, it released a report and an “action plan” identifying 15 items on which the OECD would make recommendations.

In 2015, the OECD released its final recommendations for action on the 15 areas it had identified. It describes the recommendations as “soft law.” In other words, they are not self-enforcing, and they only become effective as countries enact them, either by changing their domestic laws, modifying their existing bilateral income tax treaties or joining new multilateral treaties.

Since 2015, many countries have taken steps to enact recommendations in the action reports. Those of particular interest to insurance companies are summarized below.

1. Country-by-Country Reporting

Arguably, the recommendation most widely adopted to date has been country-by-country reporting (“CbC reporting”), a system by which MNEs will file reports on their worldwide activities with a country (generally, with the jurisdiction in which the MNE is headquartered) that will share the report with other countries pursuant to bilateral or multilateral information sharing agreements.

It is expected that, as a result of sharing CbC reports among participating countries, taxing authorities will have a global view of the operations of taxpayers over whom they can exert jurisdiction, which would provide such taxing authorities with more information with which to analyze—and potentially challenge—the reporting positions taken by taxpayers. The OECD recommends that CbC requirements apply to MNEs with annual revenues of €750 million or more.

Many countries, including the United States and Bermuda, have adopted CbC rules. In particular, the Multilateral Competent Authority Agreement on the Exchange of Country-by-Country Reports (“CbC MCAA”) provides a multinational regime for CbC reporting. The CbC MCAA was first signed in January 2016; to date, 68 countries have joined, including Bermuda, Canada, Germany, Guernsey, Ireland, the Isle of Man, Jersey, Luxembourg, Mauritius, Switzerland and the UK. The OECD released a template CbC report in March 2016. Some jurisdictions have implemented CbC reporting requirements for fiscal years starting as early as 2016.

Insurance companies with operators in multiple jurisdictions should review their operations and finances to gain insight into how taxing authorities might view reports of their worldwide activities. Internal and external compliance procedures should be reviewed to ensure that companies are, and will be able to, prepare the data required for the reports.

2. Transfer Pricing

BEPS action items 8, 9 and 10 address transfer pricing. Recommendations include specific guidance on interpreting the “arm’s length” standard, with a focus on risk transfer. These recommendations are expected to be implemented through modifications to the OECD’s transfer pricing guidelines and by countries incorporating minimum standards into their domestic laws. In May, the OECD Council approved modifications to the transfer pricing guidelines.

pricing guidelines. Additionally, some jurisdictions, such as the UK, have begun to revise their domestic laws in response to the OECD’s recommendations.

Insurance companies that expect to have significant transactions between related parties in different jurisdictions should be prepared to evaluate such transactions under evolving transfer pricing standards. Companies should plan future transactions, and engage in active monitoring of existing transactions, with an eye to compliance with these new rules as they are developed and adopted.

3. Multilateral Instrument

The 15th and final of the OECD’s BEPS action items is a “multilateral instrument” to facilitate countries’ modifications of their existing bilateral treaties. In principle, if two countries are both signatories to the multilateral convention, the multilateral instrument can provide a framework of pre-agreed options for modifying their existing bilateral treaties to incorporate the OECD’s recommended terms.

Of note to insurance companies, the multilateral instrument implements the OECD’s recommendations in action item 6, aimed at preventing persons from obtaining the benefits of double tax treaties in circumstances where they are perceived to be engaging in “treaty shopping.” The proposed multilateral instrument targets such persons by modifying the double tax treaties so as to include one of the following three provisions:

1. a principle-purpose test (“PPT”), which denies access to treaty benefits where one of the principal purposes behind establishment in a jurisdiction is to obtain treaty benefits, and, granting such treaty benefits would not be in accordance with the objectives of the relevant tax treaty;

2. a limitation-of-benefits provision (“LOB”), which denies access to treaty benefits unless the person is a “qualifying person.” The prescribed criteria that determine whether a person should be considered a “qualifying person” seek to ensure that there is a sufficient link between such a person and the relevant treaty jurisdiction; or

3. a combination of the PPT and a simplified version of the LOB.

To date, 78 countries have signed the multilateral instrument, including Canada, Germany, Guernsey, Ireland, Isle of Man, Jersey, Luxembourg, Switzerland and the UK. Consequently, insurance companies are encouraged to review their existing reliance on tax treaty benefits, whether the parties to such tax treaties have become signatories to the multilateral instrument and which of the proposed modifications have been selected by such jurisdictions from the three options set forth above.

C. UK/EU TAX DEVELOPMENTS

1. Tax Deductibility of Interest Expense

Since April 1, 2017, new UK restrictions on the tax deductibility of net interest expense came into force. The new restrictions implement recommendations in the OECD’s reports on BEPS.

The new rules restrict the deductibility of a group’s net interest expense (and other similar financing costs) which are within the charge to UK corporation tax. Groups with less than £2 million of net interest expense will not need to apply the rules. Broadly, the new rules operate to limit the amount of such net interest expense that a group can deduct against its taxable profits to:

- 30% of the tax-adjusted EBITDA of the UK group; or
- the ratio of the wider group’s net interest expense to EBITDA multiplied by the tax-adjusted EBITDA of the UK group.

There are certain insurance-specific provisions relating to how the amortized cost basis of calculation should apply to an insurer who elects to use that basis for its creditor relationships instead of fair value accounting. In addition, certain consolidated investments held by insurance groups are treated as falling outside the wider group.

2. Reform of Loss Relief

Historically, the UK had restrictive rules in relation to the ability to relieve carried-forward corporation tax losses. Losses that arise after April 1, 2017 are now subject to a new regime which gives greater flexibility in relation to how losses can be relieved. Broadly, such losses may be offset against the total taxable profits of a company and its group members, as opposed to being offset against specific types of income, as was historically the case.

This is accompanied by a restriction on the amount of taxable profits which can be relieved by carried-forward losses. Only 50% of taxable profits in excess of £5 million are available for relief by carried-forward losses.

Concerns about the impact of the restriction were raised by the insurance sector at the consultation stage, following which, specific rules were included for insurance companies carrying on a “basic life assurance and general activity business.” The rules are complex, and tax advice should be sought as to their application, where applicable.

3. Changes to the Substantial Shareholding Exemption

Broadly, the substantial shareholding exemption allows an exemption from UK corporation tax on gains in relation to “substantial shareholding” (generally, at least 10% shareholding) in a company where certain other conditions apply. For disposals of shares on or after April 1, 2017, it is no longer a requirement that the investing company be a trading company or part of a trading group before or after the disposal. The requirement that the shares must have been held for a continuous period of at least 12 months in the two years prior to their sale has been extended to a continuous holding period of 12 months in the six years leading up to their sale. There is also no longer a requirement that the company in which shares are sold continue to be a trading company (or member of a trading group) immediately after the sale of the shares, unless such sale is to a connected party.

A further extension of the substantial shareholding exemption for companies owned by “qualifying institutional investors” has also been introduced. In such cases, where at least 80% of a company’s shares are held (directly or indirectly but not through a
listed company) by qualifying institutional investors, any gains and losses will be fully exempt, regardless of the trading status of the investing or investee companies. A proportionate exemption will apply for holdings between 25% and 80%. Further, and separately, the substantial shareholding condition can be met if the investing company’s shareholding is below 10% but the acquisition cost of the shares was more than £50 million.

A company carrying on life assurance business will generally be considered a “qualifying institutional investor.”

4. New Corporate Offenses of Failure to Prevent the Facilitation of Tax Evasion

The Criminal Finances Act 2017 introduces two new strict liability corporate offenses of failure to prevent the facilitation of tax evasion, one in relation to UK tax (the “UK Offense”) and the other in relation to foreign tax (the “Foreign Offense”).

Broadly, the UK Offense is committed where a person engages in evasion of UK tax that was criminally facilitated by an “associated person” (which would include an employee or agent) of a “relevant body” (generally, corporate bodies and partnerships), and the relevant body failed to prevent the associated person facilitating that tax evasion.

The Foreign Offense is broadly similar in the way it operates in relation to evasion of foreign tax. For the Foreign Offense to apply, the “relevant body” must be established in, or carry on any part of its business in, the UK or any part of the criminal facilitation must take place in the UK.

The two offenses are subject to a defense where, at the time of the offense, the relevant body has reasonable prevention procedures in place. It is important to note that a conviction at the taxpayer level will not be a prerequisite for bringing a prosecution against the relevant body under these offenses.

5. UK’s ILS Initiative

We consider the new tax regime for ILS vehicles operating in the UK under Section II.C. above.

6. The New EU List of Non-Cooperative Tax Jurisdictions

The EU’s recently published list of non-cooperative tax jurisdictions (the “EU Blacklist”) includes 17 jurisdictions, including the Marshall Islands, Guam and Namibia. Importantly, 47 countries were placed on the so-called “greylist,” representing those countries that avoided being included on the EU Blacklist due to commitments to either: (a) improve transparency, (b) improve fair taxation, (c) improve substance requirements, and/or (d) commit to apply certain of the OECD’s BEPS minimum standards. Greylisted countries include Bermuda, Guernsey, the Isle of Man, Jersey, the Cayman Islands and Switzerland.

Greylisted counties have until the end of 2018 to follow through on their commitments before being reconsidered for inclusion on the EU Blacklist. The sanctions that apply as a result of being included on the EU Blacklist have not yet been finalized. Sanctions currently being considered include increased audits and enquiries from tax authorities on companies doing business with entities with a link to blacklisted jurisdictions, as well as the imposition of withholding taxes on payments made to entities based in such countries.

7. The EU’s Anti-Avoidance Directive

On January 28, 2016, the EU presented its proposal for an Anti-Tax Avoidance Directive (“ATAD”). The ATAD requires EU member states to implement rules restricting the deductibility of interest payments, impose an exit tax on transfers of assets, permanent establishments or corporate residence from the member state of origin, introduce a general anti-avoidance rule, introduce rules that attribute the income of a controlled foreign company to its controlling company, and introduce rules countering “hybrid mismatches” (e.g., arrangements that give rise to a double deduction or deduction without a corresponding recognition of taxable income). EU member states must generally implement these measures by January 1, 2019. The UK has already implemented many of these rules, including equivalent hybrid mismatch rules, interest deductibility restrictions (see Section VI.C.1 above) and a general anti-abuse rule. Following Brexit, it remains to be seen to what extent the UK will implement the remainder of the rules in accordance with the minimum requirements set out in ATAD.