



March 2019

# SIDLEY GLOBAL INSURANCE REVIEW

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## SIDLEY

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The insurance industry is global in nature. Insurers and reinsurers are critically important to the world economy. They assume and transfer all manner of risk across each continent, and serve as an enormous investor base for the world's capital markets and beyond. Risk is increasingly shared among traditional and new market entrants. Risk generated in one part of the world is distributed immediately across multiple markets, including to players such as other insurers, reinsurers, private equity sponsors or capital market investors. The insurance industry constantly evolves 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 international 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 over 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 the 2019 edition of the *Sidley Global Insurance Review*.

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# TABLE OF CONTENTS

<b>I. The Global Mergers and Acquisitions Market.....</b>	<b>1</b>
<b>A. North American Market .....</b>	<b>1</b>
1. Introduction .....	1
2. Life and Annuity Market.....	1
3. P&C Market .....	2
4. Health Market .....	3
5. Other Notable Activity.....	3
6. Outlook .....	4
<b>B. European and Asian Markets .....</b>	<b>4</b>
1. Introduction .....	4
2. Lloyd's .....	4
3. Broker M&A .....	4
4. Private Equity.....	4
5. Insurtech.....	5
6. Run-Off and Restructuring Market.....	5
<b>II. The Global Alternative Risk Transfer and Capital Markets.....</b>	<b>6</b>
<b>A. Life &amp; Annuity Market.....</b>	<b>6</b>
1. The State of the Reserve Financing Market.....	6
a. Introduction of SSAP 41R Clarifying Revisions .....	6
b. Principles-Based Reserving Adoption Update .....	6
c. Adoption of Reserve Financing Model Regulation.....	6
2. Regulation XXX/Regulation AXXX Transactions .....	7
<b>B. P&amp;C Market.....</b>	<b>7</b>
1. Catastrophe Bonds.....	7
2. ILS Market Response to 2018 Catastrophe Losses .....	7
3. Sidecars .....	8
4. Reinsurance Purchased for National Flood Insurance Program.....	8
5. Global ILS Initiatives.....	8
6. M&A Activity .....	9
7. Outlook Ahead.....	9
<b>C. UK's ILS Initiative .....</b>	<b>9</b>
1. Corporate Structure.....	9
a. PCC Regime .....	9
b. Registering ISPVs as PCCs .....	10
2. Tax Changes .....	10
3. Regulatory Changes.....	10
4. UK ILS Outlook.....	10
<b>D. Traditional Capital Markets.....</b>	<b>11</b>

<b>III. The Global Longevity Risk Transfer Market</b>	<b>12</b>
<b>A. Transaction Structures</b>	<b>12</b>
1. Buy-Outs	12
2. Buy-Ins	12
3. Longevity Swaps	12
4. Index-Based Trades	12
<b>B. U.S. Market</b>	<b>12</b>
<b>C. UK/European Market</b>	<b>13</b>
<b>IV. Global Regulatory and Litigation Developments</b>	<b>14</b>
<b>A. U.S. Federal Activity</b>	<b>14</b>
1. FSOC/SIFI-Related Activity	14
2. Update on U.S.-EU and U.S.-UK Covered Agreements	14
3. FIO—Future Role in Insurance	15
4. Department of Labor—Status of Fiduciary Rule—Best Interest Standard	15
5. SEC Proposed Regulation Best Interest	16
6. Derivative Transactions	16
a. Initial Margin Requirement Phase-In	16
b. IM Rules Application	17
c. IM Rules Requirements	17
<b>B. U.S.—NAIC and State Activity</b>	<b>17</b>
1. Principles-Based Reserving—Status of Implementation	17
2. NAIC Amendments to Credit for Reinsurance Model Law and Regulation in Response to Covered Agreements	17
3. Life Insurance and Annuities	18
a. NAIC Considering Amendments to Suitability in Annuity Transactions Model Regulation	18
b. NAIC Considering Circumstances Where the Use of Indexes with Limited Lifespans Should be Allowed to Illustrate Fixed Index Annuities	19
4. Health Insurance Regulation—ACA Risk Corridors and Cost Sharing Reduction Litigation	19
5. NAIC Activity Relating to International Insurance Activities	19
a. Update on IAIS Activities	19
i. ComFrame and the ICS	20
ii. The Holistic Framework	20
iii. Future Activities	20
b. NAIC Development of Group Capital Calculation Field Testing Template	20
6. NAIC Risk-Based Capital Initiatives	21
a. Changes to Life Risk-Based Capital Following Federal Tax Reform	21
b. Changes to Bond Factors	21
7. NAIC Evaluation of Insurers' Use of Big Data and Regulatory Sandbox	21
8. NYDFS Issues Guidance Regarding Life Insurers' Use of External Consumer Data in Underwriting	22
a. Unlawful Discrimination	22
b. Consumer Disclosures	22
9. NAIC Adopts Travel Insurance Model Act	23
10. NAIC Considers Application of <i>Warrantech</i> Decision to Long-Term Care Products	23

11. NAIC Adoption of Pre-Dispute Mandatory Arbitration Clauses Bulletin .....	23
12. NAIC Exploring Developing Model Act Regarding Pharmacy Benefit Managers .....	23
13. NAIC Regulatory Issues Related to Legalized Cannabis Business .....	24
<b>C. International (Non-U.S.) Insurance Issues .....</b>	<b>24</b>
1. Brexit's Impact on the European Insurance Market .....	24
a. Introduction .....	24
b. The EU Withdrawal Agreement is Passed .....	24
c. The Deadline is Extended .....	25
d. "No-Deal" Brexit .....	25
e. How are the Big (Re)insurers Preparing for Brexit? .....	26
2. Lloyd's Update .....	26
3. Insurance Distribution Directive .....	27
a. Summary of Key Changes Under the IDD .....	27
b. Developments in the Establishment of Delegated Acts, Technical Standards and Guidelines as Required Under IDD .....	28
c. How was the IDD Transposed Into UK Law? .....	29
i. HM Treasury .....	29
ii. FCA and PRA .....	29
d. Next Steps .....	29
4. SM&CR Extended to Insurers .....	29
a. Scope of the SM&CR .....	30
b. Duty of Responsibility .....	30
c. Certification Regime .....	30
d. Conduct Rules .....	31
e. Senior Managers Regime .....	31
f. Impact on Insurers .....	31
5. EU and Member State Competition Law Enforcement Activity .....	31
a. EU-Level Enforcement by the European Commission and by the EU Courts .....	31
i. European Commission .....	31
ii. EU Courts .....	32
b. National Level Enforcement in the UK .....	32
i. PRA Affirms Role of Its Secondary Competition Objective in Implementing Solvency II .....	32
ii. Competition and Markets Authority Issues Legal Orders Against Barclays Bank and Lloyds Bank for PPI Failures .....	32
iii. CMA Responds to Super Complaint Regarding "Loyalty Penalties" .....	32
iv. CMA Investigates Most Favored Nation Clauses Used by ComparetheMarket .....	32
v. FCA Launches Market Study Into General Insurance Pricing Practices .....	32
vi. CMA Concludes Market Investigation Into Investment Consultancy and Fiduciary Management Services .....	32
vii. CMA Reviews PPI Market Investigation Order 2011 .....	32
viii. FCA Opens Consultation on GI Value Measures .....	32
ix. FCA Publishes Final Report in Wholesale Insurance Broker Market Study .....	33
c. National Level Enforcement in Austria .....	33

d. National Level Enforcement in Bulgaria . . . . .	33
e. National Level Enforcement in Denmark . . . . .	33
f. National Level Enforcement in Finland . . . . .	33
g. National Level Enforcement in France . . . . .	33
h. National Level Enforcement in Germany . . . . .	33
i. National Level Enforcement in Greece . . . . .	33
j. National Level Enforcement in Hungary . . . . .	33
k. National Level Enforcement in Italy . . . . .	33
l. National Level Enforcement in Netherlands . . . . .	33
m. National Level Enforcement in Poland . . . . .	33
n. National Level Enforcement in Portugal . . . . .	33
o. National Level Enforcement in Romania . . . . .	34
p. National Level Enforcement in Sweden . . . . .	34
<b>6. Impact of the EU's GDPR on the Insurance and Reinsurance Industry . . . . .</b>	<b>34</b>
a. Brexit . . . . .	34
b. Greater Enforcement . . . . .	34
c. Application to Non-European Businesses . . . . .	34
d. One-Stop-Shop . . . . .	35
e. Controllers and Processors . . . . .	35
f. Notice and Consent . . . . .	35
g. Data Protection Officer . . . . .	35
h. Accountability . . . . .	35
i. Information Security and Breach Notification . . . . .	36
j. Increased Rights of Individuals . . . . .	36
k. Profiling . . . . .	36
l. Transfer of Personal Data from the EEA/UK . . . . .	37
m. Final Thoughts . . . . .	37
<b>V. Cyber Risk . . . . .</b>	<b>37</b>
<b>A. U.S. Cyber Risk Developments . . . . .</b>	<b>37</b>
1. State Adoption of Insurance Data Security Model Law . . . . .	37
2. Implementation of the NY Cybersecurity Regulation . . . . .	38
<b>B. UK and Europe . . . . .</b>	<b>38</b>
1. PRA Communication . . . . .	38
2. Non-Affirmative Cyber Risk . . . . .	38
3. Affirmative Cyber Risk . . . . .	38
4. Cyber Risk Strategy and Risk Appetite . . . . .	39
5. Cyber Expertise . . . . .	39
6. Next Steps . . . . .	39
7. FCA Speech on Cyber and Technology . . . . .	39
8. What Responsibilities do Firms Have? . . . . .	40

<b>VI. Select Tax Issues Affecting Insurance Companies and Products</b>	<b>40</b>
<b>A. U.S. Tax Issues</b>	<b>40</b>
1. Overview	40
2. Base Erosion Anti-Abuse Tax	40
3. Guidance on Life Insurance Reserves	40
4. Joint Committee on Taxation TCJA “Blue Book”	41
5. Technical Corrections Discussion Draft	41
a. CFCs—Downward Attribution	41
b. DAC Tax Capitalization Rates	42
c. P&C Loss Reserve Discounting	42
d. CFCs—10% Shareholder by Value	42
e. Corrections to Other Insurance Provisions	42
6. P&C Loss Reserve Discounting	42
7. Special Treatment for Loss Carrybacks for P&C Companies	42
8. Treatment of Insurance Companies Under the PFIC Provisions	43
<b>B. International Tax Issues: The OECD BEPS Project</b>	<b>43</b>
1. Country-by-Country Reporting	43
2. Modification of Tax Treaties: Multilateral Instrument	43
<b>C. UK/EU Tax Developments</b>	<b>44</b>
1. UK’s ILS Initiative	44
2. Brexit and Tax	44
3. EU Blacklist and New Bermuda Substance Laws	44
4. The EU Anti-Tax Avoidance Directives	44
5. The UK’s Profit Diversion Compliance Facility	45

## I. The Global Mergers and Acquisitions Market

### A. NORTH AMERICAN MARKET

#### 1. Introduction

Insurance industry mergers and acquisitions saw a significant rise in activity during 2018. Although the number of transactions involving a U.S.- or Bermuda-based buyer or target increased only modestly year-over-year, from 84 deals to 87 deals (the second highest deal count since 2013), aggregate deal value grew sharply from US\$14.8 billion in 2017 to US\$42.7 billion in 2018 (the second highest aggregate annual deal value since 2007).<sup>1</sup> This surge was driven in large part by a wave of property and casualty ("**P&C**") transactions, the largest of which was AXA Group's ("**AXA**") acquisition of XL Group Ltd. ("**XL Group**") for a total cash consideration of US\$15.4 billion. M&A activity in the life and health insurance space was also robust in 2018, although it did not match the year-over-year increase in P&C transactions. The aggregate deal value for announced transactions involving targets focused in life, annuity and health business saw only a slight increase, from approximately US\$8.5 billion in 2017 to US\$9 billion in 2018.

Additionally, several high-profile life and health transactions obtained required U.S. federal and state regulatory approvals during 2018. On the health side, the US\$70 billion acquisition of Aetna Inc. ("**Aetna**") by CVS Health ("**CVS**") announced in December 2017 and the US\$67 billion purchase of Express Scripts Holding Co. ("**Express Scripts**") by Cigna Corp. ("**Cigna**") announced in March 2018 each closed late last year after passing review by the U.S. Department of Justice ("**DOJ**"). In the life insurance space, the pending US\$2.7 billion acquisition of Genworth Financial Inc. ("**Genworth**") by China Oceanwide Holdings Group Co. Ltd. ("**China Oceanwide**") announced in October 2016 was cleared by the Committee of Foreign Investment in the United States ("**CFIUS**") and has obtained all required U.S. insurance regulatory approvals (although other regulatory approvals remain outstanding).

Several factors appeared to drive insurance M&A activity in 2018. Prospective buyers benefitted from the resolution of the uncertainty surrounding tax reform that had to some extent inhibited deal-making in 2017 prior to the passage of the Tax Cuts and Jobs Act of 2017 (the "**TCJA**"). Consolidation was another major theme of 2018, serving as a driver for several of the largest P&C transactions and also spurring activity in the health insurance space. Bermuda reinsurers were especially popular targets for insurers and private equity sponsors seeking to diversify and efficiently allocate a growing pool of excess capital. In the life and annuities sector, the interest in run-off business seen in 2017 remained strong in 2018, with acquirers of legacy blocks seeking growth and expansion, and sellers looking to increase their focus on core business. Across the industry, acquirers continued to show keen interest in the insurtech space, and the continued use of special purpose acquisition companies ("**SPACs**")—publicly listed vehicles formed specifically to acquire operating companies—has found its way into the insurance M&A market.

## 2. Life and Annuity Market

Deal activity in the life and annuity market during 2018 continued at a pace largely consistent with 2017, and was driven principally by the continued interest of insurers in the reinsurance or sale of legacy blocks of life and annuity business, and strategic acquisitions. We examine below some of the more noteworthy transactions in the life and annuity space.

The interest in legacy life and annuity blocks that has been a consistent theme in recent years remained very much in evidence in 2018. One high-profile example was the agreement, announced in September 2018, by Symetra Life Insurance Company ("**Symetra**") to transfer to Resolution Re all of Symetra's structured settlement annuity contracts and a block of income annuities. The statutory reserves associated with the reinsured business were US\$5.7 billion as of December 31, 2017. Symetra will continue to service the reinsured business, and after a transitional period Resolution Re will assume responsibility for management of the business' investment portfolio.

Another legacy annuity business transaction closed on November 1, 2018, when Reinsurance Group of America, Incorporated ("**RGA**") acquired from John Hancock Life Insurance Company a block of individual payout annuities and agreed to reinsure a second block of similar business written in New York, subject to the receipt of required regulatory approvals. The transaction involved an aggregate transfer of approximately US\$3 billion in statutory reserves to RGA.

On the heels of the RGA transaction, Colorado-based Great-West Lifeco Inc. ("**Great-West**") announced in January 2019 its agreement to sell via a reinsurance transaction its U.S. individual life insurance and annuity business, including closed block life insurance and annuities, to Protective Life Corporation ("**Protective**") (owned by Japan's Dai-ichi Life Holdings, Inc.) in a deal valued at US\$1.2 billion. Great-West indicated that its decision to sell was driven in large part by a desire to sharpen its focus on the retirement and asset management markets in the U.S.

Two transactions involving the sale of run-off business were announced in 2017 and consummated in 2018. On May 31, 2018, The Hartford Financial Services Group, Inc. ("**The Hartford**") announced the closing of its 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 billion. A day later, Venerable Holdings, Inc. ("**Venerable**") acquired the closed-block variable annuity business of Voya Financial, Inc. ("**Voya**"). Venerable was created by a consortium of investors led by affiliates of Apollo Global Management, LLC ("**Apollo**"), Crestview Partners and Reverence Capital Partners. As part of the deal, approximately US\$19 billion of fixed annuities reserves were ceded to reinsurance subsidiaries of Athene Holding Ltd. ("**Athene**").

Strategic acquisitions also played a significant role in the life and annuities market. A notable example was the May 2018 acquisition by Lincoln Financial Group ("**Lincoln Financial**") of Liberty Life Assurance Company of Boston ("**Liberty Life**") from Liberty Mutual Insurance Group for US\$3.3 billion in cash, a transaction that substantially raised Lincoln Financial's profile in the group benefits

<sup>1</sup> 2019 Insurance M&A Outlook: Positioning for Growth, Deloitte.

market. In connection with the transaction, Lincoln Financial ceded Liberty Life's individual life and annuity business to Protective for approximately US\$1.2 billion.

Another large strategic acquisition in the life insurance space was Western & Southern Financial Group's ("**Western & Southern**") December 31, 2018 acquisition of Gerber Life Insurance Company ("**Gerber Life**"), a wholly owned, indirect subsidiary of Nestlé S.A., for an aggregate purchase price of approximately US\$1.6 billion. Gerber Life specializes in providing simplified life insurance products to underserved middle-income families and medical stop-loss insurance to businesses. The acquisition added a leading direct-to-consumer life insurer and iconic brand to Western & Southern's diverse portfolio of financial services businesses.

Asset managers also continued to seek opportunities in the life and annuities space in 2018. For example, on March 14, 2018, an investment consortium including affiliates of Elliott Management Corporation and other investors announced the acquisition of Prosperity Life Insurance Group, LLC. The acquisition closed on January 4, 2019 for a price of US\$500 million. In another purchase by a large asset manager, The Carlyle Group ("**Carlyle**") announced on August 1, 2018 its agreement with American International Group, Inc. ("**AIG**") to purchase 19.9% of Fortitude Group Holdings, LLC ("**Fortitude Holdings**"). The transaction was intended to effect a strategic partnership in which Fortitude Re, a subsidiary of Fortitude Holdings, would become a standalone provider of reinsurance, claims handling and run-off management solutions for long-term complex P&C and life insurance risks. The transaction was valued at approximately US\$476 million and closed in November 2018.

On the regulatory front, prospective Chinese buyers of U.S.-based insurance assets may have taken encouragement from developments in connection with the pending US\$2.7 billion acquisition of Genworth by China Oceanwide. The deal, which had been announced in October 2016, was finally cleared by CFIUS in June 2018 and has obtained all required U.S. insurance regulatory approvals. CFIUS granted its approval only after the parties modified their applications multiple times to address national security concerns, including by arranging for the personal data of Genworth policyholders to be managed by a third party. As of this writing, the deal remains subject to approval by the U.S. Financial Industry Regulatory Authority ("**FINRA**"), as well as regulators in China and Canada.

### 3. P&C Market

As we noted in last year's edition of the *Sidley Global Insurance Review*, after a slow start to 2017, during which the M&A market was relatively flat until late in the year, P&C deal activity began to gain momentum in earnest in late 2017 and early 2018, and the pace of activity accelerated throughout 2018, making it the second most active year for P&C M&A in the last two decades (unadjusted for inflation), according to S&P Global Market Intelligence. The year was marked by the announcement of five US\$1 billion-plus P&C reinsurer acquisitions, including four involving U.S.- or Bermuda-based buyers or targets (the XL Group, Validus, Tokio Millennium Re and Aspen deals, each described below). Two major drivers of deal activity in 2018 were the consolidation of P&C insurers and reinsurers

(providing the combined entities with broader product offerings and capabilities, and access to alternative sources of capital and markets) and the desire of acquirers to achieve product diversification through the acquisition of specialty P&C carriers. Sellers, in turn, saw opportunities in relatively robust valuations. We examine some of the more notable P&C transactions below.

Three of the largest P&C deals of 2018 involved the consolidation of P&C insurers and reinsurers. The largest such transaction, announced in March 2018 and closed in September 2018, was AXA's US\$15.4 billion acquisition of XL Group, a Bermuda-based P&C commercial lines insurer and reinsurer. XL Group's reinsurance capabilities give AXA enhanced risk diversification with respect to its existing commercial lines insurance portfolio, and access to alternative capital. The combined company is now among the largest global P&C commercial lines platforms in the world based on annual gross written premiums. The transaction was also the largest involving a Bermuda P&C insurer since January 2014.

Another sizable deal involving the consolidation of a P&C insurer and a reinsurer was AIG's US\$5.6 billion acquisition of Validus Holdings Ltd. ("**Validus**"), which closed in July 2018. The deal brought diverse new capabilities to AIG's general insurance business by adding Validus' reinsurance platform, an insurance-linked securities ("**ILS**") asset manager, a presence at Lloyd's of London ("**Lloyd's**") and capabilities in the North American crop insurance market.

In October 2018, RenaissanceRe Holdings Ltd. ("**RenaissanceRe**") announced its proposed US\$1.5 billion acquisition of Tokio Marine Holdings Inc.'s reinsurance platform, including Tokio Millennium Re AG and Tokio Millennium Re (UK) Ltd. (collectively, "**Tokio Millennium Re**"). The deal marked the fifth US\$1 billion-plus P&C reinsurer acquisition announced in 2018.

Private equity investors also participated in 2018's wave of reinsurer acquisitions. In August 2018, affiliates of certain investment funds managed by affiliates of Apollo announced their US\$2.6 billion acquisition of Aspen Insurance Holdings Limited ("**Aspen**"), which closed in February 2019. Aspen, a reinsurer with nearly US\$13 billion of total assets and a presence in markets around the world (operating through subsidiaries in Australia, Canada, Singapore, Switzerland and the United Arab Emirates, among others), noted that Apollo's ownership would provide Aspen with additional scale and would accelerate its growth.

Specialty P&C carriers were also very much on the radar of acquirers in 2018. In July 2018, Kemper Corporation ("**Kemper**") acquired Infinity Property and Casualty Corporation, a leading provider of auto insurance focused on serving the specialty, nonstandard consumer segment, in a deal worth US\$1.3 billion. Kemper indicated that the acquisition was driven by its ambition to become a market leader in nonstandard auto insurance. And in August 2018, The Hartford announced its agreement to acquire The Navigators Group, Inc. ("**Navigators**"), the specialty insurer, for approximately US\$2.1 billion in cash. In announcing the deal, The Hartford noted that the Navigators business was complementary geographically and to its current commercial lines portfolio, and that Navigators' Lloyd's platform would help support future specialty lines growth in

markets where The Hartford does not currently underwrite or have a significant market presence. The parties anticipate that the deal will close in the first half of 2019.

#### 4. Health Market

Undeterred by the termination in 2017 of the proposed acquisition of Humana Inc. by Aetna and the proposed merger between Anthem Inc. and Cigna (in each case as a result of the failure to obtain the blessing of the DOJ), U.S. health insurers continued to seek creative solutions to address rising healthcare costs, including through vertical integration and consolidation with other healthcare industry players. Most notably, in 2018 CVS completed its acquisition of Aetna, valued at approximately US\$70 billion, and Cigna acquired Express Scripts in a deal valued at US\$67 billion (including Cigna's assumption of US\$15 billion in Express Scripts debt).

The acquisition of Aetna by CVS, announced in December 2017, obtained DOJ approval in October 2018 and closed the following month. The combined company will provide consumers with access to the resources of CVS and to Aetna's network of providers. In addition, CVS anticipates improved health outcomes and lower costs from the integration of its pharmacy data with Aetna's medical information and analytics. This transaction was one of the most recent examples of the shift towards vertical consolidation in the healthcare industry.

Cigna's acquisition of Express Scripts, which closed in December 2018, is the most high-profile, recent illustration of the growing interest of health insurers in pharmacy benefit managers ("**PBM**s"), which serve as intermediaries in negotiating drug prices and can provide an efficient means of increasing revenues and reducing costs. The DOJ cleared the transaction after concluding that there was no anti-competitive effect of the acquisition. The deal has created one of the nation's largest providers of pharmacy benefits and insurance plans, and places Cigna in direct competition with two other prominent healthcare companies with similar structures—Aetna and CVS—as well as UnitedHealth Group Inc. ("**UnitedHealth**") and its health services business, Optum, Inc.

In another PBM acquisition that closed in September 2018, WellCare Health Plans, Inc. ("**WellCare**") purchased Meridian Health Plan of Michigan Inc., Meridian Health Plan of Illinois Inc. and MeridianRx (collectively, "**Meridian**") for US\$2.5 billion in cash. WellCare indicated that the acquisition would expand and diversify its Medicaid membership, increase its Medicare Advantage presence in new markets and add a proprietary PBM platform.

On the heels of WellCare's acquisition of Meridian, UnitedHealth in late September closed its acquisition of pharmacy company Genoa Healthcare LLC ("**Genoa**") from private equity group Advent International Corp. for approximately US\$2.5 billion in cash. UnitedHealth stated that Genoa, which runs over 425 pharmacies in behavioral health centers in 46 states, would be integrated into UnitedHealth's PBM business, OptumRx.

#### 5. Other Notable Activity

The development of technology-based business models, including through the use of technology, big data and predictive analytics to create efficiencies in insurance operations, continued to be a driver of M&A activity in 2018. In addition, technology players that have not been traditional participants in the insurance industry continued to demonstrate an appetite for insurance-related investments.

In May 2018, financial services and technology-focused private equity firm Aquiline Capital Partners LLC acquired RIA in a Box LLC, a provider of compliance solutions to registered investment advisers. In July, Principal Financial Group ("**Principal**") completed its acquisition of digital wealth management platform RobustWealth, Inc., a deal that Principal indicated was intended to improve its technology platform and expand its distribution capabilities. Finally, in a deal that made headlines in August, Google parent Alphabet Inc. announced its investment of approximately US\$375 million in Oscar Insurance Corporation ("**Oscar**"), a health insurance startup offering technology-driven services for individual consumers. Oscar has received more than US\$1 billion in funding to date and intends to continue developing its claims system, and to expand from the individual and small employer market into the Medicare Advantage market in 2020.

Last year also saw the continued use of SPACs in the insurance M&A market. The largest 2018 insurance industry transaction involving a SPAC was the deal between Sirius International Insurance Group, Ltd. ("**Sirius**"), a global multiline insurance and reinsurance group, and Easterly Acquisition Corp. ("**Easterly**"), a SPAC, in which Easterly merged with a subsidiary of Sirius and became a wholly owned subsidiary of Sirius. Upon the closing of the merger in November 2018, Easterly's common stock was exchanged for Sirius' common shares at a value equal to 1.05x Sirius' adjusted diluted GAAP book value per share, with Sirius' common shares traded post-closing on the NASDAQ. In connection with the transaction, funds affiliated with Gallatin Point Capital, Carlyle, Centerbridge Partners, L.P. and Bain Capital Credit purchased US\$205 million of preference shares and US\$8 million of common shares of the combined company. Sirius noted that its new access to public equity markets would facilitate future M&A transactions, as well as organic growth.

Another SPAC-related insurance industry deal, announced in November, was the agreement by Alignvest Management Company ("**Alignvest**") to acquire Sagicor Financial Corporation Limited ("**Sagicor**"), a leading provider of insurance products and financial services in the Caribbean region, for approximately US\$536 million. The parties plan to effect the acquisition through a merger of Sagicor and a SPAC affiliated with Alignvest, with Sagicor surviving the merger. Current shareholders of Sagicor will receive a combination of cash and shares of the surviving entity. The transaction is subject to regulatory and shareholder approval, and is expected to close in the first or early second quarter of 2019. As a result of the transaction, Sagicor will be listed on the Toronto Stock Exchange, and will have access to a broader investor base, which Sagicor indicated would accelerate its organic growth and pursuit of consolidation opportunities.

## 6. Outlook

**Consolidation of Small and Medium-Sized Insurers.** 2018 was marked by a host of blockbuster transactions, including AXA's acquisition of XL Group, AIG's acquisition of Validus and RenaissanceRe's acquisition of Tokio Millennium Re. While market conditions may well continue to accommodate deals of this magnitude, we expect to see continued consolidation among small and medium-sized and less well-diversified reinsurers, as competition continues to drive down reinsurance pricing, and heavier claims burdens (due to the increased incidence of natural disasters over the past few years) are placing pressure on smaller reinsurers to combine, in order to better handle market pressures through increased economies of scale.

**Impact of Tax Reform.** U.S. tax reform is likely to continue to influence deal activity in 2019. The U.S. base erosion and anti-abuse tax (the "**BEAT**"), which was introduced as part of the TCJA, aims to disincentivize the transfer of profits overseas. Starting in 2019, the BEAT doubles from 5% to 10%. These higher rates could impose downward pressure on the profitability of companies that are subject to the BEAT, pushing those reinsurers towards further consolidation as they seek to form larger companies that can better afford the higher rates, or to diversify their activities that are not subject to the BEAT. The BEAT may also lead to new deal structures as transactions between U.S. companies and their affiliate foreign reinsurers become subject to increased tax liability.

**International Acquirers.** Interest in U.S. insurance assets from international acquirers remains strong despite foreign purchasers from certain jurisdictions continuing to face heightened regulatory scrutiny. CFIUS' approval of the Genworth deal in particular could present a path for Chinese buyers to obtain CFIUS approval for acquisitions involving U.S.-based targets, and the level of interest in U.S. insurance businesses expressed by Chinese buyers will bear watching in 2019.

**Insurtech.** Recent years have seen mounting interest on the part of insurers in the acquisition of technology-focused entities, and this is likely to remain a theme in 2019.

## B. EUROPEAN AND ASIAN MARKETS

### 1. Introduction

Notwithstanding the continuing uncertainty over Brexit, there has been healthy deal activity involving the UK and wider European insurance markets. Key activity in major sectors is discussed below.

### 2. Lloyd's

There was reasonably significant M&A activity in the Lloyd's market during 2018, exemplifying the recent pattern of heightened cross-border Lloyd's M&A activity, with further M&A activity in the Lloyd's market anticipated through 2019. Direct acquisitions in 2018 included China Re agreeing, in September, to acquire The Hanover Insurance Group's London-based Chaucer Lloyd's platform for US\$865 million, and Cincinnati Financial Corporation ("**Cincinnati Financial**") agreeing to acquire London-based global specialty underwriter MSP Underwriting Limited from Munich Reinsurance Company

("Munich Re") for £102 million (US\$135 million). The latter represents Cincinnati Financial's entry into the Lloyd's market, its first expansion outside of the U.S. market in the company's nearly 70-year history.

In August, as noted above, The Hartford agreed to acquire Connecticut-based Navigators for US\$2.1 billion and funds managed by affiliates of Apollo agreed to acquire Aspen, both of which will provide the buyers with a Lloyd's platform.

The wider benefits of acquiring a Lloyd's platform (international licenses, reputation and financial rating) are further enhanced by Lloyd's having an established Brexit solution (with Lloyd's Brussels). Thus, acquiring businesses with a Lloyd's platform provides a Brexit solution from both a UK and EU perspective, amidst the continued uncertainty around passporting rights in the context of the UK leaving the EU.

### 3. Broker M&A

The year also saw an increase in UK broker M&A, with industry commentary by Mazars indicating that the number of deals was up from 85 in 2017 to 105 in 2018. This included the merger between SSL Insurance Group and Endeavour Insurance Services, which concluded with both companies being acquired by a fund advised by private investment firm J.C. Flowers & Co. In addition, the French broker, Verlingue, was acquired ICB Group, tripling its size in the UK market.

Consolidation in the UK broker market continues to be a significant trend with the US\$5.6 billion acquisition by Marsh & McLennan Companies, Inc. ("**Marsh**") of Jardine Lloyd Thompson Group plc being signed and announced in 2018, and Arthur J. Gallagher & Co. signing a definitive agreement to acquire Stackhouse Poland Group Limited. Market commentary by Mazars suggests that nearly 40% of all UK broker M&A acquisitions were performed by a "consolidator" in 2018.

Other notable deals include London-based reinsurance, wholesale and specialty broker, Ed Broking Group, announcing that it would be acquired by a subsidiary of BGC Partners, Inc., and Integro Group Holdings LP acquiring Hawkes Bay Holdings Ltd., the privately owned principal parent company of Tyser & Co. Ltd.

### 4. Private Equity

As with 2017, the European insurance sector continues to be a source of interest for private equity firms. As insurance groups look to divest assets which they no longer consider part of their core business, many private equity firms have seen a chance to acquire these assets, in order to reinvigorate them through more efficient management and wider synergies with their own investment management skill set, in order to drive sustainable profits. This has meant that 2018 saw private equity firms, with significant investment funds at their disposal, continuing to be among the bidders for insurance entities.

In July 2018, Cinven announced its intention to acquire the Viridium Group ("**Viridium**"), a leading life insurance consolidation platform in Germany, and to provide equity funding for Viridium to acquire Generali Lebensversicherung AG (a life insurer with approximately four million policies and approximately €40 billion (US\$45.3 billion) of assets under management), in what it described as a transformational acquisition.

In August 2018, as noted above, funds managed by affiliates of Apollo agreed to acquire the global specialty insurance and reinsurance provider Aspen for US\$2.6 billion, a deal completed in February 2019. Also in August 2018, Cinven agreed to acquire AXA Life Europe for €925 million (US\$1.06 billion), and esure Group plc, a motor insurer, announced that it had agreed to a £1.2 billion takeover by private equity firm Bain Capital.

Finally, in September 2018, certain investment funds affiliated with Apollo completed their acquisition of a majority stake in Catalina Holdings (Bermuda) Ltd. ("**Catalina**").

## 5. Insurtech

Market data suggests that investment in European insurtech companies continues to grow significantly as investors shift their attention to more established startups. Traditional (re)insurance companies have demonstrated a growing interest in investing their capital into insurtech, learning lessons from the ever-increasing influence of fintech on the financial sector, and the advantages that come from using digitally focused products that make insurance more accessible and more efficient. Taking this in conjunction with perceived threats posed by potential further entrance into the market by technology firms (such as Google, Amazon, Apple and startups that are keen to disrupt the insurance sector), the major insurers have started to increase the size and scope of their investments in insurtech, to ensure that they do not fall behind.

In 2018, there were a number of European insurtech M&A transactions. In November, for example, Aviva plc ("**Aviva**") took a majority stake in London-based smart home insurance startup Neos Ventures Ltd ("**Neos**"). Aviva had previously invested in Neos through its venture capital fund in 2017, which we detailed in last year's *Sidley Global Insurance Review*. As well as offering insurance policies through a managing general agent agreement, 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 device.

The growing importance of companies focused on the internet of things ("**IoT**")—where, in effect, any device with a power switch is connected to the internet in order to obtain data related insights from its use or from its environment—was further demonstrated in September when Munich Re acquired portfolio company relayr, Inc. ("**relayr**") for US\$300 million. Relayr offers an IoT platform for helping small and medium-sized industrial companies obtain data related insights from their machinery.

Large insurers also continued to invest in insurtech startups. Munich Re invested US\$45 million in Tröv, Inc., an insurance app whereby users can protect their personal property on-demand (i.e., with the ability of turning coverage on and off through the app). In June, Zurich Insurance Group ("**Zurich**") acquired a minority stake in CoverWallet, Inc., a startup that makes it easier for businesses to understand, buy and manage insurance online. In May 2018, AXA agreed to partner with the carpooling company BlaBlaCar on a new motor insurance offering called BlaBlaSure, which offers three tiers of insurance ranging from third-party liability protection to extensive insurance for risks, including collision damage. Furthermore, Allianz

Group ("**Allianz**") has recently injected a further €570 million (US\$645 million) into its digital investment unit, Allianz X, taking the size of its fund to €1 billion.

In September 2018, Lloyd's held its inaugural Lloyd's Lab. This involved 20 teams (made up of startups, entrepreneurs and businesses) from many different countries including Canada, Israel, the Netherlands, Ireland and the UK, pitching their ideas ranging from on-demand, customizable, insurance to using the IoT for live geo-tracking and meteorological forecasting. The Lloyd's Lab provided the teams selected with a co-working space located in Lloyd's, potential funding and the chance to develop products, platforms and processes for the Lloyd's market. One example of insurtech in the Lloyd's market is the partnering between Parsyl, a startup data platform, and Antares, Ascot, Beazley and CNA Hardy, which involved insurance linked to the IoT in the context of products that require specialist storage and transportation, such as temperature-sensitive foods, biological pharmaceuticals and delicate life science products, by providing sensors that can be placed on shipments.

There have also been a number of examples of insurance brokers partnering with insurtech startups. In December 2018, Marsh partnered with wefox Group to collaborate on providing insurance products to micro-small and medium-sized enterprises ("**SMEs**") in Germany, Austria and Switzerland. This followed a similar investment by Marsh in June 2018 in UK-based Bought by Many Ltd, which also focuses on the SME market.

## 6. Run-Off and Restructuring Market

Solvency II continues to impact the way in which insurers conduct their business. In particular, annuities and products promising guaranteed returns have become less attractive for insurers as the regulatory framework requires that insurers hold funds to match liability risks. This has resulted in a number opting to adapt their business models by divesting themselves of legacy books. Standard Life Aberdeen plc sold its entire life assurance business to Phoenix Group, stating that the decision to refocus the business as an asset manager meant it could operate with "significantly lower capital requirements." Prudential plc ("**Prudential**") announced a similar move, de-merging M&G Prudential from Prudential, and selling its UK annuity book (worth US\$12 billion) to Rothesay Life plc. As noted already, Cinven agreed to acquire AXA Life Europe, which primarily manages guaranteed, unit-linked life insurance products (i.e., variable annuities) for its customer base across Germany, the UK, France, Spain, Italy and Portugal.

Other examples of activity in the run-off sector included Randall & Quilter Investment Holdings Ltd. acquiring Constanta Insurance Company (Guernsey) Limited, a captive company now in run-off, from Old Mutual plc, as well as acquiring MPS Risk Solutions Limited and Western Captive Insurance Company Designated Activity Company from the Coffey Group of companies in Ireland. Similarly, Armour Group Limited led a group of investors in the acquisition of Gibraltar-based Elite Insurance Company Limited and, in December 2018, Zurich agreed to sell its pre-2007 UK legacy employers' liability policies portfolio to Catalina.

## 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**") and a limited amount of universal life products with secondary guarantees subject to Actuarial Guideline XXXVIII (AXXX) ("**Regulation 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. Introduction of SSAP 41R Clarifying Revisions

At the March 2018 meeting of the National Association of Insurance Commissioners (the "**NAIC**"), the staff recommended that the Statutory Accounting Principles (E) Working Group (the "**SAP Working Group**") review Statement of Statutory Accounting Principles No. 41R ("**SSAP 41R**") to determine whether any revisions to the language should be made to clarify the circumstances in which surplus note accounting (rather than debt accounting) is available with respect to a particular instrument. Following its review, the SAP Working Group proposed certain revisions (which were characterized as non-substantive) specifying that surplus notes "linked" to other structures are not subordinate in nature and, therefore, should be classified as debt rather than surplus of the issuer. Following comments from interested parties, the NAIC staff suggested revised language at the August 2018 NAIC meeting that was designed to focus on the intent of SSAP 41R, which is to only allow for surplus note treatment when (i) the holders of the instrument are subordinate in right of payment to all other creditors of the issuer, other than surplus note holders, and (ii) the domiciliary state insurance commissioner controls when and if a payment of principal or interest on a surplus note will be paid. The language specifically prohibits surplus note accounting when the cash flows payable under a surplus note are linked to cash flows receivable under another instrument, including when amounts payable and receivable under a surplus note and another instrument are "netted or offset (partially or in full) eliminating or reducing the exchange of cash or assets that would normally occur throughout the duration, or at maturity" of the surplus note or instrument. As of this writing, the NAIC is working with industry representatives to continue to review and comment on the proposed revisions.

##### b. Principles-Based Reserving Adoption Update

As discussed in previous editions of the *Sidley Global Insurance Review*, Principles-Based Reserving ("**PBR**") became operative effective 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 and 2018 may have an effect on the PBR adoption rate by the industry. See section IV.B.1 for more information about the adoption of PBR.

##### c. Adoption of Reserve Financing Model Regulation

As discussed in previous editions of the *Sidley Global Insurance Review*, 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. Until the A/XXX Model Regulation is adopted and effective in each state, 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, as updated in 2017 to ensure consistency with the A/XXX Model Regulation, ("**AG 48**") apply to life insurers using affiliated captive reinsurers (each, a "**Captive**"), particularly for Regulation XXX/Regulation AXXX transactions. 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 ("**VM-20**") must be backed by "Primary Security." The concept of "**Primary Security**" includes "hard assets" (cash and securities listed by the Securities Valuation Office of the NAIC), and excludes synthetic letters of credit, contingent notes, credit-linked notes and other securities that operate in a manner similar to a letter of credit. Reserves that are required to be held by statute above the adjusted VM-20 level can be backed by "**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. The introduction of possible revisions to SSAP 41R in 2018 affecting surplus note accounting treatment has led to a shift in the structuring of Regulation XXX/Regulation AXXX transactions to ensure that the captive reinsurer issuing the surplus note can receive surplus note accounting treatment.

Other trends in the Regulation XXX/Regulation AXXX market continued to hold true in 2018. Like previous years, we understand that the majority of the deals that were completed in 2018 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 two transactions 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 2018 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. 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 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 A/XXX Model Regulation, has amplified the need for these types of transactions to provide shortfall solutions. 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.

### 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 2018 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 ILS, industry loss warranties ("**ILWs**") and collateralized reinsurance, continued to grow and as of the end of 2018, reached approximately US\$99 billion, representing approximately 16% of the estimated US\$595 billion

total capital dedicated to global property catastrophe reinsurance.<sup>2</sup> The following provides an overview of the global P&C ART market's highlights and trends of 2018 and outlook for 2019.

### 1. Catastrophe Bonds

2018 was another record year for catastrophe bond issuance. Despite the high level of 2017 loss events, investor appetite for the catastrophe bond market remained strong in 2018. There were approximately US\$13.9 billion of new issuances, resulting in approximately US\$37.8 billion in outstanding catastrophe bonds as 2018 came to a close. The first three quarters drove this record issuance, which offset a relatively subdued fourth quarter that saw a reduction in issuance volume compared to historical levels.<sup>3</sup>

In a deal notable for its size, the International Bank for Reconstruction and Development (World Bank) issued US\$1.36 billion of catastrophe bonds in February 2018 to cover earthquake risks for the benefit of Chile, Colombia, Mexico and Peru. In another notable transaction, Build America Mutual Assurance Company utilized the ILS market to secure US\$100 million of coverage for financial guarantee insurance risks. 2018 also saw additional operational risk ILS deals come to market as well as an uptick in mortgage insurance risk ILS transactions. The fourth quarter alone saw Arch Capital return to the market, and Radian Guaranty and MGIC come to the market for the first time, transferring in the aggregate over US\$1.2 billion of mortgage insurance risk.

Despite the market expansion into new classes of risk, traditional perils continued to dominate the catastrophe bond market. However, a few unique deals came to market that focused exclusively on single perils. The U.S. Federal Emergency Management Agency ("**FEMA**") obtained US\$500 million of reinsurance protection through its first flood catastrophe bond issuance. Additionally, Pacific Gas & Electric Co. (PG&E) obtained US\$200 million of reinsurance protection through a catastrophe bond covering only California wildfire risk. As of the date of this writing, the principal of this bond is facing a potentially complete mark-down due to the recent 2018 California wildfires. More generally, the spate of recent California wildfires have caused investors to increase their focus on the wildfire peril.

### 2. ILS Market Response to 2018 Catastrophe Losses

Global insured catastrophe losses in 2018 (including losses from Hurricanes Michael and Florence, Typhoons Jebi, Trami and Mangkhut and California wildfires Camp, Woolsey and Hill) totaled over US\$90 billion, 47% lower than those sustained in 2017.<sup>4</sup> Despite two years of losses totaling over US\$230 billion, the ILS market remained resilient, with alternative capital rising 11%, an increase

<sup>2</sup> *Weather, Climate & Catastrophe Insight – 2018 Annual Report*, Aon Benfield (January 2019); *Reinsurance Market Outlook*, Aon Benfield (January 2019).

<sup>3</sup> <http://www.artemis.bm/news/cat-bond-related-ils-market-ends-2018-at-new-record-size-report>.

<sup>4</sup> *Weather, Climate & Catastrophe Insight – 2018 Annual Report*, Aon Benfield (January 2019); *Reinsurance Market Outlook*, Aon Benfield (January 2019).

of US\$10 billion, to a total of US\$99 billion, while traditional capital fell 4%. This total includes about US\$9.2 billion of new non-life catastrophe bond issuances.

The impact of the 2017 and 2018 events resulted in increased amounts of collateralized reinsurance capital being lost or trapped at the January 2019 renewal. Although the industry reportedly experienced a small uptick in premium rates at the January 2019 renewals, concerns over pricing adequacy and levels of capital continue to affect some funds' ability to attract new investors. Consequently, a trend has emerged whereby certain ILS funds are placing a greater emphasis on long-standing cedant programs with stronger performance. The pricing impact of the Japanese catastrophes, including typhoons Jebi and Trami, has not yet been felt because major Japanese accounts are set to renew on April 1.

### 3. Sidecars

A number of existing sidecar vehicles returned to the market in 2018 with expanded issuances relative to 2017, including Harambee Re (sponsored by Argo), K-Cession (sponsored by Hannover Re), Mt. Logan (sponsored by Everest Re), Fibonacci Reinsurance (sponsored by RenaissanceRe) and Versutus (sponsored by Brit). In addition, a number of new sidecar vehicles came to the market in 2018, including Daedalus I Re (sponsored by XL Capital/New Ocean Capital Management), Lion Rock Re (sponsored by Peak Re), the first Asia-based cedant to set up such a vehicle, NCM Re (UK PCC) Ltd ("**NCM Re**") (sponsored by Neon Syndicate 2468), Oxbridge Re NS (sponsored by Oxbridge Re), Alturas Re (sponsored by AXIS) and Viribus Re (sponsored by MS Amlin).<sup>5</sup> This type of growth continued into early 2019 with the emergence of new sidecars, such as Lorenz Re (Torricelli 2019, sponsored by PartnerRe), Sussex Re (sponsored by Brit) and Vermeer Re (sponsored by RenaissanceRe), which is PGGM's first rated vehicle, obtaining an "A" rating from A.M. Best. Several of the new sidecars that entered the market in 2018 were also renewed in early 2019. We expect this growth to continue throughout 2019.

### 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 2018 hurricane events, the NFIP currently has US\$9.9 billion of remaining borrowing authority. After 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 response to this accumulation of debt, FEMA has entered into several reinsurance agreements to cover certain risks.

The reinsurance agreements do not reduce the size of NFIP's current debt to the Treasury Department, but rather are intended to reduce the accumulation of future debt.

In January 2018, FEMA purchased 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 for losses between US\$4 billion and US\$6 billion, and 54.3% of losses between US\$6 billion and US\$8 billion.

In August 2018, FEMA, the agency responsible for administering the NFIP, entered into a three-year reinsurance agreement with Hannover Re (Ireland) DAC which, acting as a "transformer," transferred US\$500 million of the NFIP's financial risk to capital markets investors through the issuance of catastrophe bonds. Pursuant to this agreement, Hannover Re will indemnify FEMA for a given flood event for 3.5% of losses between US\$5 billion and US\$10 billion and 13% of losses between US\$7.5 billion and US\$10 billion. In return, FEMA will pay a US\$62 million premium for the first year of coverage. This arrangement effectively transferred US\$1.96 billion of the NFIP's flood risk to the private sector for the 2018 hurricane season, marking the first time capital markets investors are backing NFIP reinsurance coverage.

In January 2019, FEMA returned to the reinsurance market, securing US\$1.32 billion of single-year protection from a panel of 28 insurers, covering 14% of losses between US\$4 billion and US\$6 billion, 25.6% of losses between US\$6 billion and US\$8 billion, and 26.6% of losses between US\$8 billion and US\$10 billion. FEMA is expected to continue to grow the NFIP's reinsurance program in the future and create new additional opportunities for traditional (re)insurers and the ILS market.

In addition, Congressman Rep. Blaine Luetkemeyer of Missouri introduced the Taxpayer Exposure Mitigation Act in Congress, which would require FEMA to purchase reinsurance or capital markets alternatives to better protect taxpayers from flood loss risk. Supporters of this bill would like to see the NFIP buy substantially more coverage and shift the risk from taxpayers to reinsurers and investors. The passage of the bill would likely result in more risk being ceded to traditional (re)insurers and ILS investors.

### 5. Global ILS Initiatives

Although Bermuda still remains the hub of ILS activity, other jurisdictions are taking steps to attract ILS market opportunities. The UK ILS market has continued to grow following the establishment of a new regulatory regime in December 2017. In May 2018, Atlas Capital UK 2018 PLC (Series 2018 ISPV 1) ("**Atlas Capital**") issued US\$300 million worth of catastrophe bonds, the first issuer of this type of securities to be domiciled in the UK. As sponsor, French reinsurance firm SCOR SE ("**SCOR**") moved away from Ireland where its previous special purpose issuers have been based, instead leveraging the UK's new regulatory regime. More deals are expected to hit the market in 2019, as new UK-domiciled vehicles are created, such as Fuchsia Capital PCC, a multi-arrangement ILS vehicle, and Sussex Capital UK PCC Limited ("**Sussex Capital**"), a multi-use collateralized reinsurance vehicle.

<sup>5</sup> See <http://www.artemis.bm/reinsurance-sidecars> for full list.

In its continuing bid to become an ILS domicile for the Asian region, the Monetary Authority of Singapore (“**MAS**”) launched the world’s first commercial cyber risk pool. The facility will provide cyber insurance to corporate buyers in the Asia region backed by both ILS and reinsurance. In addition, the MAS plans to introduce a protected cell company regulation, similar to the structure in Bermuda and the UK.

In the U.S., California Bill SB 290 was introduced in the California Senate in February 2019, which would allow the Office of Emergency Services to work with the treasurer and the insurance commissioner to purchase insurance, reinsurance and other related alternative risk transfer products.

## 6. M&A Activity

Overall, 2018 has seen a number of M&A deals hit the ILS market. In November 2018, Markel Corporation acquired Nephila, the manager of the world’s largest ILS and reinsurance-linked investment funds, in an all-cash merger totaling US\$957 million. Also in November, New Ocean Capital Management Limited was acquired by AXA XL, becoming a wholly owned subsidiary within AXA XL’s alternative capital business. The ILS market should expect more mergers and acquisitions surrounding ILS fund managers as (re) insurers look to leverage the capital markets and provide different solutions to their customers.

## 7. Outlook Ahead

As in 2018, 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 and 2018 events. We expect that traditional reinsurers will continue to explore new ways to use third-party capital to their benefit, especially in light of a fall in traditional capital this past year. In addition, we expect that the ILS market will continue to expand the lines of business and perils covered as investors become increasingly sophisticated and able to assess a broader set of risks. 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, as demonstrated by FEMA’s three-year reinsurance arrangement with Hannover Re covering flood risk and MAS’ first commercial cyber risk pool.

## C. UK’S ILS INITIATIVE

In the 2015 UK budget, 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 are composed 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 for 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: (i) the insurance risk transformation functions of the ISPV are exempt from UK corporation tax; and (ii) 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.

Of particular interest is the fact that the original consultation document published prior to the implementation of the regime indicated the UK Government believes that one attraction of the ISPV will be its ability to benefit from the UK's network of double tax treaties, for example to reduce withholding taxes on securities held as collateral. This was not repeated in the final consultation document which, in light of the ISPV's tax exempt status, led to some practitioners calling the ISPV's entitlement to treaty benefits into question. When setting up any ISPV structure careful analysis may be required to ascertain whether the ISPV is eligible to rely on such tax treaty benefits.

## 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 ("**FSMA**") (Regulated Activities Order) 2001 (the "**RAO**").

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 Managers and Certification Regime ("**SM&CR**").

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 have elapsed and the applicant has not received notification that the PRA or FCA objects to the application.

In addition, as mentioned above ISPVs will be subject to the SM&CR 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

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 relatively short time that the Regulations and Tax Regulations have been in force, the UK has already approved a number of ILS structures.

Neon was the first to establish an ILS vehicle in the UK with the launch of NCM Re, a UK-based special purpose insurance vehicle, operating as a sidecar for Neon Underwriting's Lloyd's Syndicate 2468. NCM Re received its approval from the PRA in December 2017 and the transaction was launched on January 1, 2018, with NCM Re entering into a US\$72 million quota-share reinsurance agreement with Syndicate 2468. Neon has since successfully renewed this transaction for 2019 with a slightly enlarged US\$77 million issuance. This renewal is seen as encouraging for the UK ILS market as it shows continued support from investors. It was also noted that early engagement with the PRA facilitated a smooth renewal process, highlighting the importance of early engagement with the PRA during the ILS approval/renewal process.

SCOR also made use of the recently enacted UK ILS regime for its first catastrophe bond since 2016. This transaction was the first full catastrophe bond issuance to be domiciled in the UK under the new legislation, which is a milestone in comparison to some ILS

jurisdictions where only collateralized reinsurance sidecars have been transacted to date. The catastrophe bond is being issued through Atlas Capital, which will provide SCOR with a US\$300 million of multi-peril retrocessional protection. Atlas Capital was granted full approval from the PRA in early 2018 with the transaction being completed on May 31, 2018.

In November 2018, Brit Ltd. obtained authorization for a UK multi-arrangement ISPV vehicle, through Sussex Capital. As noted above, a multi-arrangement ISPV allows for multiple cedants in a single company structure. This is seen as another milestone for the UK's ILS regime, and it is anticipated that other sponsors will make use of multi-arrangement ISPVs, now that one has successfully been launched.

In addition, Beazley is said to have sponsored Fuchsia Capital PCC Ltd. ("**Fuchsia Capital**") for use as a new ILS vehicle. Fuchsia Capital is yet to have started transacting, although it was recently confirmed by Beazley that Fuchsia Capital will be active in 2020. Beazley has not confirmed exactly how it intends to use this vehicle although it was noted that they are exploring ceding a quota share of its syndicate 2623/623's reinsurance account to Fuchsia Capital and/or using it to provide access to Beazley's "smart tracker" syndicate 5623.

It is positive that despite uncertainty around Brexit, there has been interest in the UK's ILS regime. The fact that multiple types of ILS transactions and vehicles have been established since the launch of the UK's ILS regime evidences the interest from sponsors in testing the various options available under new UK ILS regime. There are a number of other UK ILS transactions in the pipeline, which, as 2019 progresses, will help to establish the UK as a competitive ILS market.

#### D. TRADITIONAL CAPITAL MARKETS

The year saw significant activity in initial public offerings in the insurance industry. Meanwhile, the pace of capital markets transactions remained fairly constant throughout 2018 for traditional debt offerings and funding agreement-backed note issuances.

In May, AXA Equitable Holdings Inc., the American arm of AXA, raised US\$2.75 billion in the largest U.S. IPO of 2018, selling 137.25 million shares for US\$20 each.

In October, Federal Life Mutual Holding Company ("**FLMHC**"), the parent of Federal Life Insurance Company, completed its conversion from a mutual to a stock company and formed Federal Life Group, Inc. ("**FLG**") as a stock holding company. FLG completed a sale of 3,530,150 shares of its common stock at US\$10 per share in an offering to policyholders, directors, officers and employees of FLMHC and its subsidiaries as well as certain strategic partners.

Goosehead Insurance Inc., a Texas-based insurance agency, went public in April 2018 with shares priced at US\$12 and EverQuote, an online insurance marketplace, debuted in June 2018 with a US\$18 share price.

Insurance companies continue to raise funds via traditional debt offerings, typically in the form of senior note offerings. In January, Athene sold US\$1 billion 4.125% senior notes with a 10-year term. In March, The Hartford sold US\$500 million of 4.40% senior notes due 2048, with the proceeds used in part to repay US\$320 million

in senior notes maturing in March 2018. In April, Fidelity & Guaranty Life Holdings, Inc. issued US\$550 million 5.50% senior notes due 2025, using the proceeds to, *inter alia*, repay US\$135 million in borrowings under its revolving credit facility and discharge all of the outstanding US\$300 million principal amount of its 6.375% senior notes due 2021. In September 2018, Torchmark Corporation sold US\$550 million 4.550% senior notes due 2028. The Progressive Corporation sold US\$600 million 4.20% senior notes due 2048 and US\$550 million 4.00% senior notes due 2029. Great-West sold US\$300 million 4.047% senior notes due 2028 and US\$500 million 4.581% senior notes due 2048.

Also in 2018, Voya sold US\$350 million 4.7% fixed-to-floating rate junior subordinated notes due 2048. In early 2019, Western & Southern sold US\$500 million 5.15% surplus notes due in 2049.

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 U.S. pursuant to Regulation S and to "qualified institutional buyers" within the U.S. pursuant to Rule 144A. 2018 saw the usual participants in the funding agreement-backed notes market (which include Metropolitan Life Insurance Company ("**Metlife**"), New York Life Insurance Company, Massachusetts Mutual Life Insurance Company ("**MassMutual**") and Principal) as well as the life insurance companies that entered (or re-entered) the market in the past few years (which include AIG, Athene Annuity and Life Company, Reliance Standard Life Insurance Company, Protective and Guardian Life).

Regarding the disclosure of public insurers, the U.S. Securities and Exchange Commission (the "**SEC**") Staff (the "**Staff**") have provided comment letters in 2018 addressing the following areas:

- **Management's Discussion and Analysis ("**MD&A**").** MD&A continued to be the frontrunner as the topic of SEC Staff comments in 2018. The Staff has commented that it would like more fulsome disclosure of key performance indicators (whether financial or nonfinancial) relevant in the management of a company's business. The Staff has requested that the metric be defined and described, with any inherent limitations comprehensively explained.
- **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 use of non-GAAP financial measures that tailor GAAP recognition and measurement principles, do not include the same items in all reporting periods, are inconsistent with respect to treatment of similar gains and losses or exclude from performance measures normal cash operating expenses.
- **Disclosures and Controls for New Adoption Standards.** In connection with the adoption of new standards on leases and credit impairment, the Staff has focused on the requirements under Staff Accounting Bulletin (SAB) 74

regarding disclosures about how companies will be affected by the adoption of new standards. The Staff has discussed its expectations that disclosures evolve as the effective date of a new standard approaches and implementation with respect to the new standard progresses, with the expectation that disclosures become more specific each quarter.

### III. The Global Longevity Risk Transfer Market

The focus of the global alternative risk transfer market has been longevity risk. The two principal sources of longevity risk are defined benefit pension schemes and books of annuity business written by life insurers. There has been continuously high activity in both areas, with the favorable financial positioning of many pension schemes, the development of alternative de-risking options and 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 a slow-down in medical and healthcare advances to increase life expectancy, strong equity positions and increased supply by insurers and reinsurers, pension schemes are benefitting from affordable options in the market and are well-positioned 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.

#### 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; and the fact that there is no upfront payment of a lump sum premium means that 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/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 several of years, other group

annuity writers have become more active in the market, in particular MassMutual, MetLife and, more recent entrants to the market, 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 record breaking year for pension de-risking transactions in 2018. According to the LIMRA Secure Retirement Institute, the pension buy-out sales in the U.S. in the first three quarters of 2018 totaled US\$15.9 billion, topping the same period in 2017 (with sales of approximately US\$11.5 billion) by approximately 33%.

Among the largest of the pension de-risking transactions consummated in 2018 include FedEx Corp. ("**FedEx**"), AK Steel Corp. ("**AK Steel**"), TJX Cos. ("**TJX**"), Devon Energy Corp. ("**Devon**"), Materion Corp. ("**Materion**") and Archer Daniels Midland Co. ("**ADM**").

FedEx purchased a group annuity contract from Metlife to transfer approximately US\$6 billion in U.S. pension plan obligations. The transaction transferred pension benefits for approximately 41,000 FedEx retirees and beneficiaries and is the largest of any deal in the U.S. since Verizon's 2012 deal with Pru.

In its third pension de-risking transaction, AK Steel purchased a group annuity contract from MassMutual to transfer approximately US\$280 million in pension liabilities. AK Steel previously completed two buyouts with an undisclosed insurance company in 2016. Also in 2018, TJX purchased a group annuity contract to transfer US\$207 million in U.S. pension plan liabilities and Devon purchased a group annuity contract to transfer US\$190 million of its pension plan liabilities, in both cases from undisclosed insurance companies. Materion Corp. purchased a group annuity contract from Mutual of America Life Insurance Co. to transfer approximately US\$111 million in U.S. pension liabilities (representing 43.4% of total liabilities).

In the final quarter of 2018, ADM entered the pension buyout market by closing on the purchase of a group annuity contract from Pru. The transaction represents approximately US\$500 million U.S. pension liabilities and affects 3,800 retirees and beneficiaries.

As in prior years, we expect this market 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

The UK longevity market continued to witness significant growth in 2018, Hymans Robertson noting that it would likely be a record-breaking year for pension scheme buy-in and buy-out volumes. Legal & General Group Plc's buy-in of £4.4 billion of pension liabilities held by British Airways, which included the conversion of existing longevity insurance into a bulk annuity, is reported to be the largest ever deal of its kind in the UK.

A trend that first emerged in 2015 in anticipation of Solvency II coming into effect, and which has accelerated since then, 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 with a reinsurance component, such as the longevity swap

arrangement completed by Zurich covering over £2 billion of pensioner liabilities of the UK's National Grid Electricity Group of the Electricity Supply Pension Scheme, there was also activity through 2018 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.

Insurers and reinsurers have been cautioned by regulators to be aware of the consequences that come with such a rapidly growing market. In a speech at the Westminster and City Annual Conference on bulk annuities, David Rule, Executive Director of Insurance Supervision at the PRA, discussed the implications of increased competition and decisional shifts in bulk purchase annuity market. Specifically, Mr. Rule emphasized the need for insurers to critically understand the risks on prospective deals and to get the pricing on transactions right as margins become finer. He noted that insurers should be diligent in reviewing and evaluating the nature of annuity liabilities being taken on, and be particularly aware of any potential obligations toward pensioners' dependents, as well as noting that insurers should also continue to monitor counterparty and operational risks.

One of the primary pricing determinants in bulk annuity transactions is the investment return on the assets backing the annuities. In 2018, there was a significant change in the diversification of such assets from bonds into direct lending and, in particular, to equity release mortgage lending. According to the PRA, illiquid assets, such as equity release mortgage loans, made up approximately 25% of assets backing annuities across UK insurers last year and is expected to rise to around 40% by 2020. While illiquid assets may be an advantageous match for annuities for portfolio diversification, wider spreads over risk-free rates and a larger Matching Adjustment under Solvency II, Mr. Rule warned insurers of the need to thoroughly understand and manage the risks related to these assets. The changing nature of factors contributing to transaction prices means that insurers should critically evaluate their pricing processes, especially as the PRA focuses its attention on ensuring that insurers are accurately capturing compensation for the risks to which they are exposed so the Matching Adjustment is not overstated and they are holding appropriate capital against these risks.

In March 2018, the UK Department for Work and Pensions published a white paper that introduced superfunds as an alternative to complete risk transfers by traditional buy-ins and buy-outs. A pension superfund is an entity of consolidated defined benefit corporate pension schemes formed by "sponsor" companies seeking to off-load their pension schemes. The assets and liabilities of each corporate scheme are passed on to the superfund, which will then run the schemes until all of the pensions have been paid or until the scheme is able to be passed to an insurance company via a buy-out. Superfunds are funded initially by investments made by the sponsor companies and outside investors. Though superfunds are

beneficial in that they provide weaker pension schemes with the opportunity to fully transfer their liabilities for less than the cost of a full buy-out, pensioner protection concerns have arisen due to the alternative regulatory framework these superfunds are subject to. Pension superfunds will be subject to regulation by The Pensions Regulator rather than the PRA or FCA. Thus, unlike insurers providing bulk annuities under Solvency II, pension superfunds will not be subject to the same requirements to hold regulatory capital. The government has recently closed the consultation period on rules for superfunds and it is too early to tell the direction of development in, or the level of disruption caused by, this area of the longevity market, though some insurers are beginning to respond to these potential competitors with the formation of their own version of consolidation vehicles.

Though demand and competition have increased significantly in 2018, 2019 is predicted to be another record year for the longevity market in the UK as a result of increased capacity by insurers, many pension schemes reaching fully funded status (caused by positive equity investments that have been cashed out), and lower than anticipated advancements in healthcare and medicine.

#### IV. Global Regulatory and Litigation Developments

Throughout 2018, state insurance regulators continued to navigate ongoing changes at the state and federal levels with respect to both insurance and non-insurance regulation. In addition, state insurance regulators have continued their work to develop laws and regulations addressing group capital and systemic risk in the context of evolving international supervisory requirements, all the while reaffirming the U.S. system of state-based insurance regulation. Regulators have also been reconsidering regulations in diverse areas of the industry, including with respect to travel insurance and PBMs, and the industry and regulators continue to react to the changing social and economic landscape where regulation with respect to cybersecurity and use of big data continued to develop. Growth in the legalized cannabis business, where the intersection of state and federal regulation is particularly complex, has also prompted consideration by the NAIC.

##### A. U.S. FEDERAL ACTIVITY

###### 1. FSOC/SIFI-Related Activity

Although the designation process has not been eliminated outright, there are no longer any non-bank systemically important financial institutions (“**SIFIs**”). Further, the Trump administration has signaled that it is unlikely that the Financial Stability Oversight Council (“**FSOC**”) will name any new SIFIs.

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 under enhanced prudential standards.

In March 2016, 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. 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. More recently, in October 2018, FSOC rescinded the SIFI designation of Prudential Financial, Inc. and, accordingly, no non-bank SIFI designations remain in effect.

#### 2. Update on U.S.-EU and U.S.-UK Covered Agreements

Pursuant to the authority granted under 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, in September 2017, the U.S. and the EU entered into the “Bilateral Agreement Between the European Union and the United States of America on Prudential Measures Regarding Insurance and Reinsurance” (the “**U.S.-EU Covered Agreement**”). Further, in anticipation of the UK’s exit from the EU in March 2019, in December 2018, the Treasury Department and the Office of the U.S. Trade Representative (the “**USTR**”) announced their intent to enter into a “Bilateral Agreement between the U.S. and the UK on Prudential Measures Regarding Insurance and Reinsurance” (the “**U.S.-UK Covered Agreement**” and, together with the U.S.-EU Covered Agreement, the “**Covered Agreements**”). The U.S.-UK Covered Agreement is currently awaiting the expiration of a 90-day notification period to the U.S. Congress before it can be signed and come into effect.

A “covered agreement” is defined as an agreement between the U.S. and one or more foreign governments, authorities or regulatory entities regarding prudential measures with respect to insurance or reinsurance. In particular, a covered agreement provides authority for the Treasury Department and the USTR to address areas where U.S. state insurance laws treat non-U.S. insurers differently, including, as discussed further below with regard to the Covered Agreements, reinsurance collateral requirements.

The terms of each of the U.S.-EU Covered Agreement and the U.S.-UK Covered Agreement are substantially similar. The Covered Agreements address the same three areas of regulation: (i) group supervision, (ii) reinsurance and (iii) exchange of information between supervisory authorities.

With respect to group supervision, the Covered Agreements prohibit EU or UK insurance supervisory authorities from applying the solvency and capital requirements under Solvency II to the worldwide operations of U.S. insurers. U.S. insurance groups that operate in an EU member country or the UK can only be supervised at the worldwide group level by U.S. insurance supervisors. Likewise, group supervision of insurers based in EU member countries or in the UK is solely the responsibility of the insurance supervisory authority in the EU member country or UK, as applicable. While the Covered Agreements do not require the development of a group capital standard or group capital requirement in the U.S., they do contemplate that the states will develop a group-wide capital

assessment. The group capital assessment condition is not applicable to U.S. insurance groups that do not have operations in the EU or UK. The NAIC is in the process of developing a group capital calculation (see section IV.B.5.b below), which is expected to satisfy this condition.

The main focus of the Covered Agreements is the changes with respect to reinsurance collateral requirements, which would prohibit a U.S. territory (i.e., each state) from imposing any reinsurance collateral requirements upon an EU or UK assuming reinsurer that would result in such reinsurer receiving less favorable treatment than assuming reinsurers domiciled in that state. In turn, an EU member country and the UK may not impose any local presence or other similar restrictions which would result in a U.S. reinsurer receiving less favorable treatment than an EU or UK assuming reinsurer that is domiciled (or has their head office), licensed or permitted to operate in the UK or the same EU member country as the ceding insurer. The collateral elimination requirements of the Covered Agreements do not apply to reinsurance agreements that were entered into before, or to losses that were incurred or to collateral that was posted before, the applicable Covered Agreement became effective. The U.S.-EU Covered Agreement officially came into force on April 4, 2018 and the U.S.-UK Covered Agreement is expected to become effective following the UK's exit from the EU. Nothing in the Covered Agreements alters the capacity of parties to any reinsurance agreement to agree on requirements for collateral in excess of those required by law.

Since the signing of the U.S.-EU Covered Agreement, the NAIC has been working to adopt amendments to the Credit for Reinsurance Model Law and Regulation to conform to the requirements of the Covered Agreements. U.S. regulators have 60 months from September 2017, the date the U.S.-EU Covered Agreement was signed, to adopt reinsurance reforms consistent with the Covered Agreements. Adoption of proposed changes to the Credit for Reinsurance Model Law and Regulation by the NAIC has been delayed as a result of the NAIC's consideration of comments issued by the Treasury Department and the USTR. See section IV.B.2 below for further discussion regarding the status of current NAIC initiatives with regard to the implementation of the Covered Agreements.

### 3. FIO—Future Role in Insurance

Under Title V of 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 Terrorism Risk Insurance Program and has a non-voting seat on FSOC.

At the beginning of the Trump administration, the role of the FIO seemed uncertain given the departure of the FIO's director and U.S. House of Representatives (the "**House**") Republicans' proposals to reduce the authority of the FIO. In the last Congress, members of the House Financial Services Subcommittee on Housing and Insurance introduced a bill to eliminate FIO's role in any domestic insurance

issues and confine its work to international insurance issues. The bill stalled in committee and is not expected to be taken up by the new Democratic-controlled House.

After a year and half without a Director, in June 2018, Treasury Secretary Steven Mnuchin appointed Steven J. Dreyer as Director of FIO. In November 2018, after less than five months in this position, Mr. Dreyer announced his departure from the FIO. Secretary Mnuchin has not yet named a replacement.

### 4. Department of Labor—Status of Fiduciary Rule—Best Interest Standard

On Thursday, March 15, 2018, in a two-to-one decision, the U.S. Court of Appeals for the Fifth Circuit (the "**Fifth Circuit**") vacated the Department of Labor's ("**DOL**") fiduciary rule and related exemptions (the "**Fiduciary Rule**") in its entirety. The Fiduciary Rule, among other things, jettisoned DOL's prior definition of "fiduciary," which had been in effect for 40 years, and thereby, in embracing the common law understanding of fiduciary relationships, dramatically expanded the circumstances under which financial and insurance professionals become fiduciaries for purposes of the Employee Retirement Income Security Act ("**ERISA**") and the prohibited-transaction provisions of the Internal Revenue Code. As the Fifth Circuit explained, the prior definition "captured the essence of a fiduciary relationship known to the common law as a special relationship of trust and confidence between the fiduciary and his client." The Fiduciary Rule departed from this common law understanding by eliminating the requirements that an "investment advice fiduciary's" business "... be its 'regular' work on behalf of a client" and that "the client's reliance on that advice [be] the 'primary basis' for her investment decisions."

The Fifth Circuit, in reversing the lower court's decision upholding the Fiduciary Rule, stated that the Fiduciary Rule "conflicts with the plain text of the 'investment advice fiduciary' provision [in ERISA] ... and it is inconsistent with the entirety of ERISA's 'fiduciary' definition." As a result, DOL "lacked statutory authority to promulgate the [Fiduciary] Rule with its overreaching definition of 'investment advice fiduciary.'"

The court went on to explain that, even if ERISA were silent or ambiguous regarding this definition, the Fiduciary Rule, for a host of reasons, does not satisfy the reasonableness test for upholding an agency's interpretation and "bears hallmarks of ... arbitrary and capricious exercises of administrative power." Among other things, the Fifth Circuit explained that the best interest contract exemption (the "**BIC Exemption**"), one of the exemptions included in the Fiduciary Rule, would impermissibly create a private right of action for owners of individual retirement accounts ("**IRAs**"). The court stated that the BIC Exemption circumvents the statutory rules applicable to IRAs. The court pointed out that IRAs are not subject to ERISA but, instead, are subject to section 4975 of the Internal Revenue Code, which does not provide a private right of action for owners of IRAs. The court also noted the significant impact the Fiduciary Rule has had on the financial services industry and the confusion created by the Fiduciary Rule, including the BIC Exemption.

According to the DOL's regulatory agenda for fall 2018, the DOL is considering regulatory options in light of the Fifth Circuit's opinion. See section IV.B.3.a on the NAIC's activities related to the amendments to Suitability in Annuity Transactions Model Regulation.

## 5. SEC Proposed Regulation Best Interest

On April 18, 2018, the SEC released for comment three proposals intended to enhance the standard of conduct for investment professionals and to reaffirm and clarify the terms of existing relationships between investors and investment professionals. The proposals have been long in the works as harmonization of the standards of conduct governing advisers and broker-dealers have been discussed for more than two decades. They are also seen by many as a response to the DOL Fiduciary Rule (see section IV.A.4 above), which was criticized by many as unduly occupying territory best left to the SEC, as well as reducing investor choices given its restrictions.

The three SEC proposals are:

- **Regulation Best Interest.** A new rule that would require broker-dealers and associated persons to act in the best interest of a retail customer when recommending a securities transaction or investment strategy involving securities to a retail customer. The proposal would require broker-dealers to act without placing the financial or other interests of the broker-dealer or associated person ahead of the customer when making an investment recommendation;
- **Investment Adviser Interpretation.** An interpretation of the fiduciary standard of conduct for investment advisers, including a duty of care and a duty of loyalty. The SEC also requested comment on proposals that would require licensing and continuing education requirements for personnel of SEC-registered investment advisers; delivery of account statements to clients with investment advisory accounts; and new financial responsibility requirements for SEC-registered investment advisers; and
- **Form CRS/Relationship Summary.** A new rule that would require broker-dealers and registered investment advisers to provide a brief relationship summary to investors at the beginning of a relationship and in connection with any material changes. The summary would address the relationships and services the firm offers, the standard of conduct and the fees and costs of the services, specified conflicts of interest and whether the firm and its financial professionals have reportable legal or disciplinary events.

The obligations under the Regulation Best would be satisfied if the broker-dealer does all of the following:

- **Disclosure Obligation.** Reasonably discloses, in writing, to the retail investor the material facts both with regard to the scope and terms of their relationship and with respect to any specific investment recommendation.

- **Care Obligation.** Exercises reasonable diligence, care, skill and prudence with regard to the broker-dealer's recommendations.
- **Conflict of Interest Obligation.** Establishes and maintains conflict of interest policies that, at a minimum, (i) disclose, or eliminate, all material conflicts of interest associated with the recommendation and (ii) disclose and mitigate, or eliminate, material conflicts arising from financial incentives associated with the recommendation.

Notably, Regulation Best Interest would not prohibit a firm from selling higher cost or complex products, including insurance products, such as variable annuities.

The comment period for the SEC's rulemaking closed on August 7, 2018, and the rule is pending. Comments were split with the brokerage industry (the Securities Industry and Financial Markets Association, the financial services institute which represents independent broker-dealers and financial advisers) generally supporting the proposal with some suggested modifications and consumer groups and at least one state agency (Consumer Federation, Public Investors Arbitration Bar, Massachusetts Securities Commission) criticizing it as too weak. The Investment Adviser Association supported the goals but raised significant concerns regarding "whether the proposal will actually increase investor confusion." While consensus will be challenging to obtain, there is a reasonable chance that Regulation Best Interest will be adopted in some form in 2019. Both Chairman Clayton and Commissioner Hester Peirce have indicated that completing Regulation Best Interest is a high priority. The other Republican Commissioner, Elad Roisman, was confirmed after the proposal and has not indicated how he will vote. Commissioner Robert Jackson was critical of the proposal but voted for it. Meanwhile, Commissioner Kara Stein, who voted against the proposal, has left the Commission and it is not clear whether her replacement will be confirmed in time to participate. Moreover, there may be additional pressure to put a rule in place before a new administration that conceivably could seek to impose a more burdensome regime. See section IV.B.3.a for an update on the NAIC's activities related to the amendments to Suitability in Annuity Transactions Model Regulation.

## 6. Derivative Transactions

### a. Initial Margin Requirement Phase-In

In the derivatives markets, the most notable development during 2018 was the launch of initiatives to start to comply with the initial margin rules<sup>6</sup> (the "**IM Rules**") that will phase in on September 1, 2019 and September 1, 2020—dates that will capture a broader range of end-user derivatives customers, including some insurance companies. While September 1, 2019 or 2020 may seem far off, advanced planning will be required in order for affected end-users

<sup>6</sup> The initial margin requirements are part of the margin regulatory requirements adopted by the Commodity Futures Trading Commission in the "Margin Requirements for Uncleared Swaps for Swap Dealers and Major Swap Participants" and collectively by the Treasury Department, Office of the Comptroller of the Currency, Board of Governors of the Federal Reserve System, Federal Deposit Insurance Corporation, Farm Credit Administration and the Federal Housing Finance Agency in the "Margin and Capital Requirements for Covered Swap Entities" final rules.

and their dealer counterparties to be able to continue trading post-September 1, 2019 or 2020. End-users who are subject to the IM Rules will need time to prepare for their implementation. Compliance with the IM Rules will likely require that existing trading documentation be amended, or that new initial margin ("**IM**") compliant documentation be entered into between the parties. Further, compliance with the IM Rules will also require the parties to establish custody relationships with a third-party custodian as well as implementation of methods to monitor relevant threshold calculations on an ongoing basis, as required under the IM Rules.

In order to determine whether an end-user is subject to the September 1, 2019 or 2020 phase-in compliance date, a series of calculations are required with respect to the derivatives trading activity of the end-user during a specified period in 2018. Because these calculations are unique to each end-user, dealers will require end-users to certify their status under the IM Rules phase-in. The International Swaps and Derivatives Association, Inc. ("**ISDA**") published a self-disclosure letter in 2018 that can be used by end-users to certify their status under the IM Rules and identify whether they expect to be in scope for the September 2019 phase-in date or the September 1, 2020 date.

### b. IM Rules Application

The IM Rules require registered swap dealers to both post and collect IM from any counterparty that is a "financial end user"<sup>7</sup> with "material swaps exposure." Accordingly, end-users will be required to both post, and receive, IM with their swap dealer counterparties. An end-user has "material swaps exposure" if it and its affiliates had a daily average aggregate notional amount ("**AANA**") of uncleared Over-The-Counter ("**OTC**") derivatives across all counterparties for June, July and August of the previous calendar year that exceeded US\$8 billion. For this purpose, uncleared OTC derivatives include all uncleared U.S. Commodity Futures Trading Commission-regulated swaps, SEC-regulated security-based swaps and foreign exchange derivatives and forwards and the AANA calculations are to be made on a gross basis. Further, affiliation is determined by reference to accounting consolidation principles. Thus, an entity generally will be deemed an "affiliate" of another entity for purposes of calculating material swaps exposure if: (i) either entity consolidates the other on financial statements prepared in accordance with applicable accounting principles (or would be required to consolidate the other on its financial statements if such applicable accounting principles applied), or (ii) both entities are consolidated with a third entity on a financial statement prepared in accordance with applicable accounting principles (or would be consolidated on a financial statement of a third entity if such accounting principles applied). The September 1, 2019 phase-in date applies with respect to end-users that (along with all of its affiliates) have an AANA for March, April and May of 2019 that exceeds US\$750 billion, otherwise the September 1, 2020 phase-in date will apply to all other financial end users with material swaps exposure.

<sup>7</sup> Regulated insurance companies are, by definition, "financial end-users." However, insurance holding companies or other parent companies that are not otherwise licensed as an insurance company are not automatically captured by the financial end-user definition.

### c. IM Rules Requirements

The IM Rules require IM to be posted and collected, subject to a permitted threshold of up to US\$50 million. IM posted must be in the form of prescribed eligible collateral, which is limited under the IM Rules to cash (limited to major currencies) and limited, highly liquid securities. Under the IM Rules, all collateral posted as IM must be held by an independent third-party custodian that is not affiliated with either counterparty. Non-cash collateral may alternatively be held via other legally binding arrangements that protect the posting counterparty from the default or insolvency of the collecting counterparty. However, any non-cash collateral held by the posting counterparty must be held in insolvency-remote custody accounts. The IM Rules also require that the amount of IM to be posted be calculated using either a risk-based IM model or by reference to a look-up table of standardized minimum amounts set out in the appropriate IM Rules. ISDA has developed the ISDA Standard Initial Margin Model ("**ISDA SIMM**") to provide a common IM calculation methodology that can be used by market participants globally. Any party using ISDA SIMM to calculate IM, regardless of whether such party, such party's counterparty, or a third-party vendor is the party that actually calculates the IM amount, must execute a license agreement to use ISDA SIMM.

## B. U.S.—NAIC AND STATE ACTIVITY

### 1. Principles-Based Reserving— Status of Implementation

PBR became operative effective January 1, 2017 in accordance with the NAIC's Standard Valuation Manual (Valuation Manual), which was adopted by the NAIC in June 2016. As of the beginning of 2019, all states and the District of Columbia have enacted legislation implementing PBR. Notably, while New York initially opposed PBR, in 2018, New York enacted legislation implementing PBR. PBR will not become effective in New York until January 1, 2020. The NAIC has made adoption of PBR an accreditation standard, effective January 1, 2020.

### 2. NAIC Amendments to Credit for Reinsurance Model Law and Regulation in Response to Covered Agreements

At the NAIC's fall national meeting (the "**Fall National Meeting**"), the Reinsurance (E) Task Force (the "**Reinsurance Task Force**") and the Financial Condition (E) Committee (the "**(E) Committee**") voted to adopt amendments to the NAIC's Credit for Reinsurance Model Law and the Credit for Reinsurance Model Regulation (together, the "**CFR Model Laws**") to implement reinsurance collateral reforms for reinsurers that meet certain conditions, as required in connection with the Covered Agreements. The amendments were expected to be officially adopted by the NAIC during a meeting of the Executive Committee and Plenary on December 19, 2018. However, the vote was delayed following the receipt of additional comments issued by the Treasury Department and the USTR. See section IV.A.2 for further discussion regarding the status of the Covered Agreements.

In light of these developments, on February 11, 2019, the (E) Committee published a memorandum recommending that the Reinsurance Task Force and its drafting group consider making

additional revisions to the proposed amendments to the CFR Model Laws to address certain issues raised by the Treasury Department, the European Commission, other regulators and interested parties. The categories of issues identified include: (a) recognition of reciprocal jurisdictions, (b) determination of compliance with the Covered Agreements, (c) commissioner discretion to impose additional requirements, (d) effective date, (e) service of process, (f) additional requirements for Qualified Jurisdictions, (g) recognition of the U.S. state regulatory system by Qualified Jurisdictions and (h) recognition of NAIC accredited jurisdictions as reciprocal jurisdictions.

During a conference call on February 19, 2019, the (E) Committee voted to adopt its recommendations as set forth in the February 11, 2019 memorandum. It is expected that the Reinsurance Task Force will resolve the above-mentioned issues and release a revised draft of the proposed amendments to the CFR Model Laws in advance of the Spring 2019 National Meeting. The (E) Committee and the Reinsurance Task Force will try to adopt the revised proposed amendments to the CFR Model Laws by early May 2019.

The amendments to the CFR Model Laws previously adopted by the Reinsurance Task Force and the (E) Committee at the Fall National Meeting: (a) eliminate reinsurance collateral requirements for EU- and UK-based reinsurers meeting the conditions of the applicable Covered Agreement; (b) extend similar treatment to reinsurers from other jurisdictions covered by potential future covered agreements; and (c) extend similar treatment to reinsurers domiciled in “reciprocal jurisdictions” that are not necessarily parties to existing or future covered agreements. These amendments would allow a U.S. ceding insurer to take 100% credit for reinsurance for transactions with non-U.S. reinsurers that meet all of the following requirements (in relevant part):

- **Reciprocal Jurisdiction.** The assuming reinsurer has its head office, or is domiciled, in a “reciprocal jurisdiction.” A “reciprocal jurisdiction” includes: (i) any non-U.S. jurisdiction that has entered into a treaty or international agreement with the U.S. regarding credit for reinsurance; and (ii) any “qualified jurisdiction” (for certified reinsurer purposes) that is not a party to such an agreement with the U.S. and that satisfies certain requirements with respect to the treatment of U.S. reinsurers operating in such jurisdiction.
- **Minimum Capital and Surplus.** The assuming reinsurer maintains minimum capital and surplus (or its equivalent) of not less than US\$250 million.
- **Minimums Solvency or Capital Ratio.** The assuming reinsurer maintains a prescribed minimum solvency or capital ratio.
- **U.S. Jurisdiction/Filings.** The assuming reinsurer agrees to be subject to U.S. jurisdiction for certain limited purposes and to make certain informational filings with state insurance departments.

### 3. Life Insurance and Annuities

#### a. NAIC Considering Amendments to Suitability in Annuity Transactions Model Regulation

Throughout 2018, the Annuity Suitability (A) Working Group (“**ASWG**”) worked on amendments to the NAIC’s Suitability in Annuity Transactions Model Regulation (“**SAT**”) to better align the state standards governing the standard of care of insurance producers with the federal standards governing the standard of care of investment advisers. At the Fall National Meeting, the Life Insurance and Annuities (A) Committee (the “**(A) Committee**”) voted to expose the draft amendments for comment. Such vote occurred over objections made by both California and New York that consideration of the amendments by the (A) Committee was inappropriate in light of the fact that the ASWG, which was charged with drafting the amendments, had not officially voted to adopt the proposed amendments. During discussion, the Chair of the ASWG and the Chair of the (A) Committee explained that further federal regulation (from both the SEC and the DOL) is expected in 2019 with respect to the “best interest” standard and, in the interest of “harmonization between regulatory enforcers,” it might be necessary to pause the development of the amendments until the NAIC has further clarity around the proposed federal rules. See section IV.A.4 and section IV.A.5 for further discussion regarding the current status of such proposed federal rules from the DOL and SEC.

Notably, the draft amendments exposed for comment do not adopt a standard that expressly references the “best interest” of the consumer. By way of explanation, the ASWG added the following drafting note to the current version of the draft amendments: “[T]he NAIC is not yet convinced that this November 2018 Draft of the amended *Suitability in Annuity Transactions Model Regulation* (#275) is legally distinct from the enhanced standards that are intended by the SEC. Until such time [as] the NAIC can evaluate any distinction in the text of the SEC proposal between a “best interest” recommendation and investment adviser fiduciary duties, and the SEC and FINRA have finalized relevant terms, definitions and related requirements, the NAIC would opt to refrain from using the phrase ‘best interest’ in section 6A(1) of the proposed modifications to the *Suitability in Annuity Transactions Model Regulation* (#275).”

As currently proposed, the amendments to the SAT would require a producer (or an insurer where no producer is involved), when making a recommendation to an individual consumer regarding the purchase, exchange or replacement of an annuity, to “act in the interests of the consumer at the time the recommendation is made, without placing the producer’s or the insurer’s financial interest ahead of the consumer’s interests.” Under the current draft, a producer (or insurer) would comply with this requirement (in relevant part) by: (a) “[a]cting with reasonable diligence, care, skill and prudence”; (b) making suitable recommendations (as further described in the SAT); and (c) making certain disclosures, including the cash and non-cash compensation to be received by the producer in connection with the transaction and “[a]ny and all material conflicts of interest.”

Meanwhile, in 2018, the New York State Department of Financial Services (the “**NYDFS**”) finalized amendments to its insurance regulations governing suitability in annuity transactions (New York

Insurance Regulation 187), to require, among other things, that insurance producers (or insurers) comply with a “best interest” standard in connection with both life insurance and annuity transactions with consumers. During the Summer National Meeting, in response to a request from New York, the (A) Committee agreed to consider, in connection with its review of the proposed amendments to the SAT, whether the scope of the SAT should be expanded to include both life insurance and annuity transactions. The (A) Committee did not discuss that issue when voting on the draft amendments to the SAT at the Fall National Meeting, although it is possible that the (A) Committee will revisit the issue in connection with reviewing comments received on the exposed draft.

#### **b. NAIC Considering Circumstances Where the Use of Indexes with Limited Lifespans Should be Allowed to Illustrate Fixed Index Annuities**

The Annuity Disclosure (A) Working Group (“**ADWG**”) is working on revisions to the Annuity Disclosure Model Regulation (#245) to allow for the use of indexes that have been in existence for less than 10 years in fixed index annuity illustrations. Such use is currently prohibited in states that have adopted the relevant portion of the current version of Model 245. In June 2018, the ADWG exposed for comment draft revisions to Model 245, which would allow illustrations to use an index in existence for less than 10 years, provided that: (a) the index satisfies certain other criteria (e.g., the index is comprised entirely of components that have been in existence for at least 10 years, the index value is calculated according to an algorithm that is not subject to discretion, and if the insurance company is affiliated with the index provider, indexes published by that index provider are also used by entities unaffiliated with the insurance company); and (b) certain disclosures accompany the illustration. Despite working on the issue for over a year, the ADWG has been unable to reach consensus regarding appropriate revisions. The ADWG has agreed to form a small drafting group to develop additional language for review and discussion. In light of this, the (A) Committee granted an extension of the model law development request to the Spring 2019 National Meeting.

### **4. Health Insurance Regulation—ACA Risk Corridors and Cost Sharing Reduction Litigation**

In June 2018, a three-judge panel of the U.S. Court of Appeals for the Federal Circuit (the “**Federal Circuit**”) issued an opinion in four risk corridors cases that had been consolidated for appeal. By a 2-1 majority, the panel concluded that the U.S. government does not have to pay insurers the full amount of risk corridors payments under the formula in the Patient Protection and Affordable Care Act’s (“**ACA**”) risk corridors statute and regulations. The decision overturned one decision in favor of insurers in the U.S. Court of Federal Claims (“**Court of Federal Claims**”), but was consistent with rulings in two other cases in that court in favor of the government. Unless overturned by the U.S. Supreme Court, the decision will deprive insurers of more than US\$12 billion in risk corridors payments under the ACA.

The risk corridors program was intended to protect insurers from extreme gains and losses during the initial years of the ACA. Under a three-year program in effect from 2014 to 2016, qualified health plans

with lower than expected claims were required to make payments to the Centers for Medicare & Medicaid Services (“**CMS**”), while plans with higher than expected claims would 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 and lawsuits followed.

In reaching its holding, the Federal Circuit first determined that the plain language of the ACA entitled insurers to full risk corridors payments. That obligation, however, was thereafter suspended and/or repealed due to subsequent appropriation riders adopted by Congress. Accordingly, the Federal Circuit concluded that no additional monies were owed beyond the limited funds paid into the risk corridors program by insurers themselves. One judge from the Federal Circuit panel issued a dissent. Four insurers filed writs of certiorari to the U.S. Supreme Court in February 2019.

Litigation has also ensued over governmental non-payment in respect of another ACA program, the cost-sharing reduction (“**CSR**”) payments program. Nearly a dozen lawsuits, including one class action, have been filed by insurers against the government for failure to pay the CSR payments owed under the ACA’s cost sharing reduction statute and regulations. CSR payments are designed to make healthcare 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. The government subsequently ceased making those payments.

In February 2019, two judges in the Court of Federal Claims granted summary judgment to insurers in four CSR cases. These decisions joined two CSR decisions entered in favor of insurers by a third judge in the fall of 2018. Insurers have thus won all six of the CSR cases resolved to date by the courts. Ironically, the strongest support for the CSR claimants may be the Federal Circuit’s decision in the risk corridors cases, where similar statutory language was found to create an unambiguous obligation to make risk corridors payments. Unlike in the risk corridors context, the CSR courts found this clear statutory obligation was not abrogated by a subsequent appropriation rider or other act of Congress. The government has already filed a notice of appeal respecting the two earlier CSR decisions, and is expected to do likewise for the four recent CSR decisions. Briefing of the CSR cases before the Federal Circuit is expected to run through summer 2019.

### **5. NAIC Activity Relating to International Insurance Activities**

#### **a. Update on IAIS Activities**

The International Association of Insurance Supervisors (the “**IAIS**”) plans to finalize several important initiatives in 2019, including the Common Framework for the Supervision of Internationally Active Insurance Groups (“**ComFrame**”), the Insurance Capital Standard Version 2.0 (“**ICS**”) and the recently published Holistic Framework for Systemic Risk in the Insurance Sector (the “**Holistic Framework**”).

### i. ComFrame and the ICS

ComFrame is a set of international supervisory requirements focusing on the effective group-wide supervision of internationally active insurance groups (“**IAIGs**”). A key part of ComFrame is the development of a risk-based, global ICS for IAIGs. The IAIS is reviewing comments regarding the current drafts of both ComFrame and the ICS received from stakeholders in response to a consultation period that ended October 30, 2018, and is expected to release a revised version of ComFrame in June 2019.

As concerns the ICS, the IAIS is finalizing design options for the 2019 field testing process, which will inform the ICS version that is ultimately approved at year-end for implementation in 2020. It is expected that implementation of the ICS will be conducted in two phases: a five-year “monitoring period,” during which the ICS will be used for confidential reporting to the group-wide supervisor and discussion in supervisory colleges; and thereafter, the implementation of the ICS as a group-wide prescribed capital requirement.

### ii. The Holistic Framework

In late 2018, the IAIS published its proposed Holistic Framework for a public consultation period that ended January 25, 2019. The Holistic Framework seeks to assess and mitigate systemic risk in the insurance sector by focusing on an “activities” based approach. It recognizes that systemic risk may arise from not only the impairment of individual insurers but also the collective activities and exposures of insurers at a sector-wide level. The Holistic Framework is slated for adoption in late 2019, with implementation beginning in 2020.

The Holistic Framework’s approach to systemic risk is “holistic” in three primary respects:

- **Relevant Sources.** It takes into account both relevant sources of systemic risk (i.e., those arising from the potential impact of effects resulting from the impairment of individual insurers, and those arising from the spreading of shocks from solvent entities, through their collective risk exposures or responses to shocks);
- **Cross-Sectoral Aspects.** It addresses cross-sectoral aspects of systemic risk by comparing the potential systemic risk of insurers with other parts of the financial system, notably the banking sector; and
- **Proportionate Approach.** It moves away from a binary approach whereby certain additional policy measures are only applied to a relatively small group of insurers (i.e., the specified Global Systemically Important Insurers) to an approach with a proportionate application of an enhanced set of policy measures to address activities and exposures that can lead to systemic risk targeted to a broader portion of the insurance sector.

The key elements of the Holistic Framework are as follows:

- **Enhanced Supervisory Measures.** As the preemptive part of the framework, an enhanced set of supervisory policy measures for macroprudential purposes;

- **Global Monitoring Exercise.** A global monitoring exercise by the IAIS designed to detect the possible build-up of systemic risk;
- **Intervention.** When a potential systemic risk is detected, supervisory powers of intervention that enable a prompt and appropriate response;
- **Consistent Application.** Mechanisms designed to ensure a globally consistent application of the framework; and
- **IAIS Assessment.** The IAIS’ assessment of the consistent implementation of enhanced ongoing supervisory policy measures and powers of intervention.

### iii. Future Activities

Once the IAIS’ activities with respect to ComFrame, the ICS and the Holistic Framework are finalized, as part of its strategic plan for 2020 through 2024, the IAIS will focus on emerging risks in the areas of climate change, cybersecurity, fintech, sustainable development and digital inclusion (e.g., initiatives to ensure that all individuals, including those in disadvantaged and underserved communities, have access to and knowledge regarding the use of digital technology, including the internet).

### b. NAIC Development of Group Capital Calculation Field Testing Template

The Group Capital Calculation (E) Working Group (the “**GCC Working Group**”) is considering revisions to the group capital calculation (“**GCC**”) field testing template and related instructions (the “**Template**”) in response to comments received from stakeholders following exposure of the Template for a comment period that ended January 30, 2019. By way of background, the Template is in furtherance of the NAIC’s efforts to develop an analytical tool for regulators to evaluate the financial condition of an insurance group through a U.S. GCC using a risk-based capital aggregation methodology. The GCC Working Group emphasized that the Template is a preliminary draft that will be further revised following its analysis of issues emerging from the field testing results. To that end, the Template was designed to provide maximum flexibility and multiple testing criteria and options in order to analyze the impact of tentative possibilities for a GCC. For example, the exposed version of the Template allows for: multiple grouping options (e.g., grouping based on the type of entity such as banking entities or asset managers); exclusion of certain entities from its scope (e.g., certain entities within a group may be excluded based on lack of materiality); and multiple adjustments (e.g., allowance of subordinated debt as additional capital and Regulation XXX/Regulation AXXX reserve adjustments).

Furthermore, there are no limits on the types of groups that may participate in the field testing (e.g., groups with non-U.S. and federal regulators may participate in order to provide additional perspectives). The GCC Working Group expects that the field testing will enable it to better evaluate, among other matters, whether: the tentative possibilities for a GCC provide the desired result for the

GCC; there are any unintended consequences; and any additional data points or factors need to be considered to serve the objective of the GCC.

The GCC Working Group authorized the NAIC to incorporate any non-substantive, technical stakeholder comments into the Template and release a revised Template in late February 2019. The GCC Working Group will consider whether to further revise the Template based on substantive stakeholder comments during its next scheduled conference call in March 2019 or at the NAIC's Spring National Meeting in April 2019. Such comments included, for example, recommendations that: the Template conform to domestic state legal entity requirements without adjustment (i.e., to avoid one set of solvency measures at the legal entity level and a different set of measures at the group level); all adjustments to legal entity rules should be characterized as on-top adjustments (i.e., on top adjustments are presently limited to adjustments related to Regulation XXX/Regulation AXXX captives); the impact of on-top adjustments should be discernible so that the "baseline" of the Template always conforms to existing legal entity rules; and certain of the proposed adjustments (e.g., adjustments for Regulation XXX/Regulation AXXX captives and non-admitted entities) should be exposed for public comment.

The initial round of field testing is anticipated to begin once the GCC Working Group determines whether any further revision to the Template is required based on the substantive stakeholder comments. Field testing participation will be voluntary.

## 6. NAIC Risk-Based Capital Initiatives

### a. Changes to Life Risk-Based Capital Following Federal Tax Reform

In June 2018, the Capital Adequacy (E) Task Force approved changes to the life risk-based capital ("**RBC**") formula to account for the effects of the TCJA, specifically focusing on changes to the RBC ratio denominator in order to reflect the corporate tax rate decrease from 35% to 21%. Such changes were subsequently adopted by the Financial Condition (E) Committee and Plenary. With the assistance of the American Academy of Actuaries (the "**AAA**"), the Life Risk-Based Capital (E) Working Group (the "**Life RBC WG**") is preparing a guidance document for state regulators to use in evaluating companies' year-end 2018 RBC ratios in light of tax reform and these recently adopted changes to the RBC factors and instructions. The purpose of the document is to serve as a starting point for future communications from the Life RBC WG to a broader group of state regulators in order to assist state regulators in interpreting the results of year-end 2018 life RBC calculations in light of tax reform. The Life RBC WG anticipates that the guidance document will be completed in early 2019, such that state regulators will be able to use it as a resource in reviewing the results of year-end 2018 life RBC calculations.

### b. Changes to Bond Factors

The Investment Risk-Based Capital (E) Working Group (the "**Investment RBC WG**") is considering changes to the bond factors used in the Property/Casualty RBC Formula and the Health RBC Formula, as recommended by the AAA. The AAA recommends the

development of a set of bond factors that includes an offset for the level of credit risk reflected in statutory reserves. The level of credit risk assumed to be reflected in statutory policy reserves acts as an offset to the total credit risk modeled in the C1 bond factors, which is based on the risk premium and the default portion of the asset valuation reserve. The AAA recommends that the assumption for risk premium be set at the mean or expected level of the credit loss distribution, which is consistent with the existing solvency framework and C1 bond factors.

The Investment RBC WG is also considering a recommendation from the AAA that the NAIC consider increasing the granularity in bond factors used in the Property/Casualty RBC Formula and the Health RBC Formula by expanding the number of bond rating classes from six to 20, as well as updating the factors. The AAA recommends that, in order to increase consistency between both the Property/Casualty RBC Formula and the Health RBC Formula, as well as to increase consistency between similar bond factors between different lines of business, the NAIC should consider an increase in bond factors granularity and update the factors.

## 7. NAIC Evaluation of Insurers' Use of Big Data and Regulatory Sandbox

The NAIC is continuing its review of P&C insurers' use of predictive modeling in rate filings and is developing related guidance materials for states to use in reviewing predictive models. The NAIC also continues to consider insurers' use of big data in underwriting life insurance products. Insurers' use of predictive modeling continues to expand and, in response to such growing use, the Casualty Actuarial and Statistical (C) Task Force has drafted a white paper to provide guidance on best practices in addressing: (a) the sources of data used by companies; (b) data points selected by companies as inputs for predictive modeling; (c) how the predictive models were developed and the results that they produce; and (d) final rate filings with states. The white paper identifies best practices currently used in a number of states and provides guidance for regulators in implementing those best practices.

The NAIC has also been exploring the concept of insurance regulatory "sandboxes," whereby insurers would have a forum to develop and introduce new and innovative insurance products under relaxed state insurance laws. The American Insurance Association (the "**AIA**") has drafted a proposed model law, titled "Insurance Innovation Regulatory Variance or Waiver Act," and is encouraging the NAIC and its member states to act to create legislative avenues to allow for insurance regulatory sandboxes. Key objectives of the AIA's proposed regulatory sandbox model law include providing a supervised process for pilot testing and experimenting with new insurance products, services and technologies while relaxing specific legal and regulatory requirements by providing targeted relief in the form of variances, waivers or no-action letters for approved sandbox participants. The proposed model law also provides for strong protections of trade secrets and certain communications between sandbox participants and state regulators, while also providing a limited amount of information and disclosure to lawmakers and the public.

To date, no state has enacted an insurance regulatory sandbox and the NAIC has not adopted the proposed model law, although the Iowa Insurance Department contends that it has the authority to grant relief under current Iowa law for innovative products in a manner similar to that of a regulatory sandbox. Additionally, the District of Columbia recently announced that it has established a Financial Services Regulatory Sandbox and Innovation Council. This council will be led by the Commissioner of the District of Columbia Department of Insurance, Securities and Banking and is charged with studying and reporting on the feasibility of implementing a financial services regulatory sandbox in the District of Columbia. Separately, foreign jurisdictions outside of the U.S. have acted to create insurance regulatory sandboxes, including in Australia, Singapore and the UK. Other industries have also been active in creating and implementing regulatory sandboxes, with Arizona implementing the first state regulatory sandbox for fintech companies in 2018 and the federal Consumer Financial Protection Bureau announcing plans to develop and implement a regulatory sandbox-type program as well.

## 8. NYDFS Issues Guidance Regarding Life Insurers' Use of External Consumer Data in Underwriting

On January 18, 2019, the NYDFS issued Circular Letter 2019-1 (the "**Circular Letter**"), addressing insurers' use of external consumer data and information sources in underwriting for life insurance. The Circular Letter follows an investigation commenced by NYDFS regarding life insurers' use of external data, which was initiated in light of reports that insurers were using algorithms and predictive models that include unconventional sources or types of external data. Among other things, the Circular Letter provides guidance that when insurers use external data sources in connection with underwriting decisions: (i) the use of external data sources must not result in any unlawful discrimination, (ii) the underwriting or rating guidelines must be based on sound actuarial principles and (iii) life insurers must have adequate consumer disclosures to notify insureds or potential insureds of the right to receive the specific reasons for any adverse underwriting decision based on such data.

### a. Unlawful Discrimination

Based on its investigation, NYDFS determined that life insurers' use of external data sources in underwriting has a strong potential to mask prohibited discriminatory practices and that use of certain algorithms and predictive models may also lack a sufficient rationale or actuarial basis. The Circular Letter defines "external data" to include any data or information sources not directly related to the medical condition of the applicant that is used, in whole or in part, to supplement traditional medical underwriting, as a proxy for traditional medical underwriting or to establish "lifestyle indicators" that may contribute to an underwriting assessment of an applicant for life insurance coverage. The Circular Letter reiterates that existing laws prohibit life insurers from making underwriting decisions based on race, color, creed, national origin, status as a victim of domestic violence, past lawful travel or sexual orientation and limit insurers from relying on physical or mental disability, impairment or disease, or history of disability or disease. Importantly, NYDFS notes that insurers are responsible for complying with the antidiscrimination laws regardless of whether an insurer itself collected the data or whether the insurer is relying on external data sources, algorithms of external

vendors or predictive models that collect or use prohibited data. In other words, insurers may not use an external data source to collect or use information that the insurer would otherwise be prohibited from collecting or using directly. The Circular Letter clarifies that the burden of compliance with such antidiscrimination laws rests with the insurer and that diligence will be required when insurers receive external data from third-party vendors.

In addition, when evaluating whether an underwriting or rating guideline derived from external data sources is unfairly discriminatory, insurers should consider (i) whether the underwriting or rating guideline is supported by generally accepted actuarial principles or actual or reasonable anticipated experience that justifies different results for otherwise similarly situated applicants, and (ii) whether there is a valid explanation for the differential treatment of similarly situated applicants. This includes, for example, models and algorithms that purport to make predictions about a consumer's health status based on factors such as the consumer's retail purchase history, social media, internet or mobile activity, geographic location tracking, the condition or type of the consumer's electronic device or the consumer's appearance in a photograph. The Circular Letter specifically notes that even if statistical data supports an underwriting or rating guideline, there must still be a valid rationale or explanation supporting the differential treatment of otherwise similar risks. Therefore, an insurer may not rely on external data or external predictive algorithms or models unless the insurer has determined that the external data or predictive model is otherwise permitted by law or regulation and is based on sound actuarial principles or experience that justifies any resulting differential treatment of otherwise like risks.

### b. Consumer Disclosures

The Circular Letter also clarifies that when life insurers use external data sources in making underwriting decisions, they must adhere to section 4224(a)(2) of the New York Insurance Law and notify the insured or potential insured of their right to receive the specific reasons for a declination, limitation, rate differential or other adverse underwriting decision, including, controversially, the failure to qualify for an accelerated underwriting process as compared to traditional medical underwriting. This includes the specific source of the information on which the insurer based its adverse underwriting decision. The insurer may not rely on the proprietary nature of a third-party vendor's algorithmic processes to justify a lack of specificity. The Circular Letter goes on to say that failure to adequately disclose to a consumer the material elements of an accelerated or algorithmic underwriting process, and the external data sources on which it relies, may constitute an unfair trade practice.

Life insurers interested in using external data sources, algorithms or predictive modeling in accelerated underwriting processes should exercise caution to ensure that the use of data contained in such materials is not unlawfully discriminatory and would otherwise be permitted by law or regulation. In addition, life insurers should be aware that they are responsible for establishing that the external data sources, algorithms or predictive models are based on sound actuarial principles and that they must notify insureds or potential insureds of their right to receive the specific reasons for any adverse underwriting decision. Finally, life insurers are ultimately responsible

for ensuring compliance with such laws through diligence, even in the event that such external data, algorithm or predictive model is provided by a third-party vendor.

## 9. NAIC Adopts Travel Insurance Model Act

In 2018, the NAIC adopted the 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 NAIC Travel Model Act provides a comprehensive framework for regulating travel insurance and other travel-related products, prescribing rules related to, among other things, the licensing of limited lines travel insurance producers, required disclosures to consumers in connection with the sale of travel insurance, premium taxes and marketing practices. The NAIC Travel Model Act allows travel protection plans that include insurance and non-insurance products to be bundled and offered to consumers for one price if the travel protection plan clearly discloses to the consumer at or prior to the time of purchase that it includes travel insurance, travel assistance services and cancellation fee waivers, as applicable, and provides information and an opportunity at or prior to the time of purchase for the consumer to obtain additional information regarding the features and pricing of each. The NAIC Travel Model Act makes it an unfair trade practice to market blanket travel insurance coverage as free. The NAIC Travel Model Act also includes a prohibition against requiring consumers to opt out of the purchase of travel insurance (such as by unchecking a box) when booking travel plans.

The Travel Insurance (C) Working Group used the National Council of Insurance Legislators (“**NCOIL**”) Travel Model Act as the starting point for developing the NAIC Travel Model Act. At least 40 states have adopted some form of the NCOIL Travel Model Act, so it is unclear how widely the NAIC Travel Model Act will be adopted by the states.

## 10. NAIC Considers Application of *Warrantech* Decision to Long-Term Care Products

At the Fall National Meeting, the Receivership and Insolvency (E) Task Force (the “**RITF**”) heard comments from interested parties regarding pending litigation in Pennsylvania related to whether the assets of the insolvent estates in the Penn Treaty/American Network liquidations can be used to pay benefit claims that accrued more than 30 days after the liquidation date and that exceed the applicable guaranty association coverage limits. At issue is the applicability of the Supreme Court of Pennsylvania’s decision in the case of *Warrantech Consumer Products Services, Inc. v. Reliance Insurance Company in Liquidation* (“**Warrantech**”), which held that the estate of an insolvent P&C insurer was not liable for service contract claims that arose 30 days after the order of liquidation of such insurer.

In applications currently pending before the Penn Treaty/American Network liquidation court, groups of health insurers asked the Penn Treaty/American Network liquidation court to apply the *Warrantech* decision to uncovered benefits that have accrued more than 30 days after the Penn Treaty/American Network liquidation date. Interested parties, including the American Council of Life Insurers, have asserted to RITF that it would be inappropriate to apply *Warrantech* to long-term care insurance or other life or health insurance products, which,

unlike the P&C insurance claims at issue in *Warrantech*, are long-duration products. Comments from interested parties also suggest that the issue may be an anomaly of Pennsylvania’s receivership and insolvency laws, which do not include an on-point provision from the NAIC’s Insurer Receivership Model Act (#555) that distinguishes between the rule applicable to life, disability income, long-term care, health insurance and annuities and the rule applicable to other types of insurance.

After reviewing comments from interested parties, RITF determined not to take any action that could influence the outcome of the pending litigation in Pennsylvania. Instead, RITF decided to monitor developments in the pending cases and to research the extent to which the Pennsylvania statute at issue in *Warrantech* differs from similar laws in other states.

## 11. NAIC Adoption of Pre-Dispute Mandatory Arbitration Clauses Bulletin

The Market Regulation and Consumer Affairs (D) Committee adopted the Pre-Dispute Mandatory Arbitration Clauses Bulletin, which prohibits the use of pre-dispute mandatory arbitration clauses and choice-of-venue and choice-of-law provisions in personal lines insurance policies. While not having the force of law, the bulletin is available to any NAIC member state for use in communicating its policy to disallow such provisions.

As adopted, the bulletin defines “pre-dispute mandatory arbitration clause” to mean a provision “requiring that future disputes involving the insurance policy or claims thereunder must be resolved through arbitration by allowing one party to the dispute to so require when the dispute arises.” “Personal lines insurance” is defined to include homeowners, tenants, private passenger non-fleet automobile, mobile manufactured home and other P&C insurance for personal, family or household needs.

The bulletin includes an exception from the general prohibition against pre-dispute mandatory arbitration clauses for those situations where arbitration provisions are specifically authorized or required by state insurance laws (such as state laws authorizing or requiring that disputed valuations of auto property damage claims or disputes over uninsured and underinsured motorist damages be resolved through arbitration). The bulletin also recognizes that arbitration may have benefits and would allow the parties’ mutual election of arbitration after the dispute arises. With respect to personal lines insurance policies, the bulletin prohibits choice-of-law provisions that would import the law of a state other than the insured’s state of residence and choice-of-venue provisions that would require the insured to travel outside of their state of residence to adjudicate a claim.

## 12. NAIC Exploring Developing Model Act Regarding Pharmacy Benefit Managers

The Regulatory Framework (B) Task Force (“**RFTF**”) established a new subgroup to evaluate the need for additional regulation of PBMs. This work is part of a broader discussion occurring at the Health Insurance and Managed Care (B) Committee and within its related working groups regarding healthcare cost drivers, including pharmaceutical costs. PBMs are facing increased scrutiny following President Trump’s

policy proposals to lower prescription drug costs, including the potential elimination of “middlemen” such as PBMs involved in the delivery of prescription drug benefits.

Members of the Task Force noted that, in connection with the development of recent amendments to the NAIC’s Health Carrier Prescription Drug Benefit Management Model Act, the RFTF had decided early on to regulate PBMs indirectly, by providing that the health carrier must ensure that the PBM is complying with the requirements of the laws and regulations applicable to the activities performed by the PBM. However, because of the increased scrutiny on PBMs, at the Summer National Meeting the RFTF decided to form a subgroup to review existing state licensing regimes applicable to PBMs and to explore the appropriate regulatory framework, if any, to be developed with respect to the licensure of PBMs.

The RFTF is aware that NCOIL is drafting a Pharmacy Benefits Manager Licensure and Regulation Model Act, which would give state insurance regulators increased jurisdiction over the activities of PBMs. The NCOIL model is based on recently adopted Arkansas legislation addressing the regulation and licensure of PBMs. It is expected that the RFTF’s newly formed subgroup will consider whether the NAIC should support NCOIL’s proposed PBM legislation or, alternatively, develop additional NAIC guidance related to the regulation of PBMs.

### 13. NAIC Regulatory Issues Related to Legalized Cannabis Business

The NAIC recently formed the Cannabis Insurance (C) Working Group (the “**Cannabis WG**”), which is charged with considering the insurance regulatory issues surrounding the legalized cannabis business, including availability and scope of coverage, workers’ compensation issues, and consumer information and protection. At the Fall National Meeting in November 2018, the Cannabis WG met in person for the first time to hear reports and presentations regarding the cannabis insurance industry. Among other things, these presentations raised as issues the need for clarity between state and federal laws regarding the legality of cannabis and the regulation of cannabis and the cannabis insurance industry, as well as a need by the cannabis industry for greater access to the services of financial institutions and insurers. The Cannabis WG is in the process of drafting a white paper outlining issues and making recommendations for the development of related regulatory guidance. The Cannabis WG expects to complete its work on this white paper by the first quarter of 2020.

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

### 1. Brexit’s Impact on the European Insurance Market

#### a. Introduction

On June 23, 2016, the UK voted by referendum to leave the EU. To formally begin the process of leaving the EU, the UK government triggered Article 50 (the EU’s legal requirement for countries wishing to leave the EU) in March 2017. This started the beginning of a two-year countdown, culminating on March 29, 2019, when the UK is scheduled to officially leave the EU. During this period, the UK has been negotiating the terms of its relationship with the EU following

Brexit. In June 2018, UK Parliament passed the European Union (Withdrawal) Act (“**EU Withdrawal Act**”). This sets out the position of the UK upon exit, whereby the EU will no longer be the source of any of the UK’s laws and any new EU laws will not be transposed into UK law. In addition, the EU Withdrawal Act transposes existing EU legislation into UK law.

Further, in November 2018, the UK and EU negotiators agreed on the wording of a potential withdrawal agreement (“**EU Withdrawal Agreement**”),<sup>8</sup> which sets out the precise terms of the relationship between the two immediately after exit day. In order for this agreement to be ratified though, it must be approved by the European Council, the EU Parliament and crucially, the UK Parliament. On November 25, 2018, the text of the negotiated EU Withdrawal Agreement was endorsed by EU leaders at a specially convened European Council meeting. However, on January 15, 2019, UK Parliament voted against the agreement, consequently halting any further progress. Since this vote, the UK and the EU have commenced further negotiations on the EU Withdrawal Agreement and UK Parliament was given another opportunity to vote on a renegotiated agreement. On March 14, 2019, the UK Parliament rejected the renegotiated agreement and voted on a motion to extend Article 50, meaning that Brexit could be delayed by three months, to June 30, 2019. However, it still remains unclear as to whether such an extension would be accepted, as any delay would need to be agreed to by the other 27 EU member states.

Therefore, at the time of this publication, there is still much uncertainty around the outcome of the Brexit negotiations and whether or not the UK will leave the EU with or without a deal. Accordingly, as noted above, there are three possible outcomes: (i) the EU Withdrawal Agreement (defined below) is passed (with possible amendments) through Parliament and its terms are adopted; (ii) the exit deadline is further extended to allow for further negotiations; or (iii) the UK leaves the EU with no deal. These are discussed in further detail below.

#### b. The EU Withdrawal Agreement is Passed

Although the EU Withdrawal Agreement lays out the precise terms of the relationship between the UK and the EU immediately after exit day, it is not a final conclusion on how the future relationship between the UK and EU will be. Rather, it is more akin to a transitional agreement, created with the intention of providing each side with more time to negotiate a more complex and comprehensive agreement which will allow for a smoother separation between the two parties. Significantly, the EU Withdrawal Agreement provides for a transition period, which would run from exit day until the end of 2020, with the UK having the option to extend this period by one or two years (both the UK and EU would have to agree to any extension and the decision must be taken before July 1, 2020). During this period, the UK would officially cease to be a member of the EU and would have no representation on EU bodies. However, the UK would continue to be under the same obligations as an EU member, for example, remaining in the EU’s customs union and single market and adhering to EU law.

<sup>8</sup> Officially titled the “Draft Agreement on the withdrawal of the United Kingdom of Great Britain and Northern Ireland from the European Union and the European Atomic Energy Community.”

Importantly, in the context of the European insurance market, this implementation period would allow for the continuation of passporting rights. As such, (re)insurers and intermediaries would be allowed to passport from the UK into the EU and vice versa after exit day, up until December 31, 2020, just as they would have been able to before Brexit. Essentially, the status quo would be preserved while the UK and EU could negotiate their own bespoke trade deal, which would itself address the issue of passporting and whether or not this system will be kept in place or replaced by an alternative.

### c. The Deadline is Extended

Alternatively, the deadline day could be extended beyond the March 29, 2019, to allow further time for the UK and the EU to reach an agreement that they believe is more beneficial for both parties, which would cater for a softer Brexit. Were this to happen, the UK's legislation would not be altered and would continue to be subject to EU law, until ultimately the new deadline day would have passed. Therefore, passporting rights would continue as normal during this interval. However, this option would require the unanimous agreement of the UK and the remaining member states, and would only be a temporary solution while the two parties agree on the best course of action and a new deadline day—after which passporting rights would cease or be replaced. Additionally, it is difficult to ascertain how long the deadline could be extended, with some EU officials suggesting only a few weeks (to finalize ratification and iron out any legal niceties), while others have advocated longer to potentially allow time for a second referendum. Similarly, many have insisted that Brexit must be concluded before the European elections at the end of May 2019, as they think it would be legally impossible for a country to be a member of the EU without participating in the elections. Yet, as has become the norm with Brexit, there is much uncertainty around this and no guarantee as to what could be decided, if any extension is agreed to at all.

### d. “No-Deal” Brexit

Finally, if neither of the above two options are agreed to, the UK will be leaving the EU on March 29, 2019, with no trade deal with the EU. This is commonly referred to as a “no-deal” Brexit. In this circumstance, the provisions of the EU Withdrawal Act will take effect to repeal the European Communities Act, convert EU legislation into applicable domestic law in the UK and amend such laws to enable them to operate following Brexit.

In the context of insurance, Parliament published The Solvency II and Insurance (Amendment, etc.) (EU Exit) Regulations 2019 on October 9, 2018 and The Insurance Distribution (Amendment) (EU Exit) Regulations 2019 on November 21, 2018, which will both come into effect on exit day in the event of a “no-deal” Brexit. Both of these statutory instruments address and resolve discrepancies that will arise when the retained EU law is transposed into UK domestic law. For example, functions will be transferred from EU entities to the appropriate UK bodies and cross references to EU legislation will be replaced with references to the relevant UK statutes. Accordingly, these statutory instruments guarantee that the legislation continues to operate effectively and seamlessly from exit day to ensure that the UK continues to have a functioning financial services regulatory regime, even if a “no-deal” Brexit scenario comes to fruition. As there are a

number of onshoring changes that will be implemented pursuant to the EU Withdrawal Act, Her Majesty's Treasury (“**HM Treasury**”) granted the Bank of England, the PRA and the FCA with temporary powers to allow a transitional period for UK-regulated firms to comply with any regulatory obligations that have changed as a result of the onshoring of financial services legislation. It was made clear in the PRA's and FCA's Brexit Policy Statements<sup>9</sup> (published in February 2019), that they intend to use these powers broadly such that they will grant transitional relief to UK-regulated firms in relation to compliance with most of their onshored regulatory obligations (subject to a few obligations where transitional relief will not be granted), with the PRA confirming that it intends to provide transitional relief for 15 months with the possibility of extension for a further two years if warranted. This is intended to provide increased certainty and continuity to UK-regulated firms and alleviate the risk of such firms having to ensure compliance with all the onshoring changes by exit day.

In addition, under the EU Withdrawal Act, as currently drafted, the right to passport into the UK would be repealed on March 29, 2019, meaning that firms currently “passporting” into the UK would no longer be able to carry on regulated activities in the UK without full authorization. To combat this, the UK government has proposed the temporary permissions regime (“**TPR**”), which is a prospective scheme for firms that are incorporated in the European Economic Area (“**EEA**”) but currently operate in the UK through “passporting” under an existing European passport framework. Accordingly, in the event that the UK leaves the EU without a deal, the TPR will come into force and will allow EEA regulated firms that wish to continue providing certain services in the UK in the longer term, to continue operating in the UK for a period of time while they wait to obtain authorization from the UK regulators.

Firms would be eligible to enter the TPR if: (i) they have applied to the UK regulators for Part 4A authorization on or before March 29, 2019; or (ii) they exercise the right to passport into the UK under a freedom to provide services or a freedom of establishment passport (including firms that currently passport into the UK and have a top-up permission). If such firms elect to enter the TPR, they would obtain a “deemed Part 4A permission” to carry on the regulated activities in the UK for a maximum of three years following Brexit, subject to HM Treasury having the power to extend the duration of the regime by increments of 12 months.

The window for submission of a TPR notification to the UK regulators has already started and is due to expire on March 28, 2019. If a firm has not notified the appropriate regulator of their intention to enter the TPR by March 28, 2019, it is currently proposed that they will not be able to enter it after this date.

The PRA and FCA released consultation papers<sup>10</sup> in October 2018, which outlined the proposed rules and regulations that would apply

<sup>9</sup> PRA Policy Statement: PS 5/19 on the Bank of England's amendments to financial services legislation under the European Union (Withdrawal) Act 2018 and the FCA Policy Statement: PS 19/5 on Brexit Policy Statement and Transitional Directions.

<sup>10</sup> PRA Consultation Paper: CP 26/18 on the UK withdrawal from the EU: Changes to the PRA Rulebook and onshored Binding Technical Standards and FCA Consultation Paper: CP 18/29 on the Temporary permissions regime for inbound firms and funds (FCA).

to firms that enter the TPR. They have since released their Brexit Policy Statements (as referred to above) which contain (among others) the near-final rules that will apply to TPR firms. Firms that are intending to enter the TPR should review these Policy Statements to ensure that they can comply with these rules and regulations, should the TPR come into force on March 29, 2019. Although, in relation to certain requirements (such as solvency and minimum capital requirements), the UK regulators have proposed that transitional relief may apply, as they appreciate that it may be difficult for TPR firms to be fully compliant with certain of the new rules and regulations applicable to them on exit day.

Although the TPR is viewed as a welcome step towards providing certainty for EEA regulated entities operating in the UK, there are still concerns around how regulated firms can continue to honor their contractual obligations if they are not covered by the TPR. In response to this, the UK Government published the Financial Services Contracts Regime ("**FSCR**") Statutory Instrument, which aims to establish a "Supervised Run-Off" and "Contractual Run-Off" mechanism. These will serve as a "back-stop" to the TPR by allowing firms that do not enter the TPR, or leave it without the appropriate permissions, to service pre-existing contracts for a limited period after Brexit. For insurance contracts, it is proposed that firms will be allowed to operate under the FSCR for a maximum of 15 years (which is significantly longer than most other contracts, which have a maximum of five years).

It is not just the UK regulators that have considered the preservation of "passporting" rights in the eventuality of a "no-deal" Brexit. Some EU member states, such as Germany, have established initiatives similar to the TPR, which would provide measures for UK-regulated entities to continue "passporting" for a limited period of time after Brexit. In addition, the European Insurance and Occupational Pensions Authority ("**EIOPA**") published recommendations to EU supervisory authorities on February 19, 2019, encouraging them to allow UK insurance companies to continue servicing their existing cross-border insurance contracts even if they are not properly authorized in that particular EU jurisdiction. It is expected that most supervisory authorities will act upon EIOPA's recommendations, therefore, providing some comfort to UK insurers who have been concerned about their ability to continue servicing their EU policyholders in a "no-deal" Brexit environment.

#### e. How are the Big (Re)insurers Preparing for Brexit?

As a result of the uncertainty surrounding Brexit, EU (re)insurers have taken steps to prepare for the possibility of a "no-deal" Brexit and have put contingency plans in place to allow themselves to adapt to a post-Brexit environment. Many (re)insurers have established new subsidiaries within the EU to act as their European hubs. Moreover, there has been a significant rise in the number of Part VII transfers (a court-sanctioned method to transfer books of insurance policies from one legal entity to another) as (re)insurers are looking to move business from their UK entities to their new or existing continental entities to ensure the straightforward continuation of their European operations after exit day.

## 2. Lloyd's Update

With much of the groundwork laid in 2018 to initiate significant changes in the marketplace, 2019 will continue to be an active year at Lloyd's. The introduction of a new CEO and the lasting sting from recent years of poor performance are driving the effort for Lloyd's to re-focus on sustainable and profitable growth. While some efforts have already been underway, including the establishment of a Brexit strategy, modernization efforts, strategic geographical operations and performance reviews, these areas will be subject to further pressure and progress this year.

As previously indicated, in light of Brexit, Lloyd's has established its new European insurance company in Belgium (Lloyd's Insurance Company S.A.) ("**Lloyd's Brussels**"), which received regulatory approval from the National Bank of Belgium in May 2018 and was operational shortly thereafter, placing and processing 2019 business in the EEA beginning November 2018. Lloyd's Brussels is Lloyd's first Europe-wide operation, with 19 branches throughout Europe (including the UK) and with licenses to write all non-life risks from the EEA. All legacy EEA business will be moved to Lloyd's Brussels before the end of 2020 through a Part VII transfer, though Lloyd's has confirmed that its underwriters will continue to pay all valid claims regardless of whether or not a transition period will result from Brexit negotiations. The formation of Lloyd's Brussels, which will utilize electronic placement and digital data capture processes, demonstrates Lloyd's commitment to remaining accessible as a key player in the European and wider global insurance space.

In prior years, Lloyd's has continued to expand its local presences and local establishments away from its base in London by establishing new international offices in emerging market locations, such as Mexico City, Mexico; Bogota, Colombia; Dubai, United Arab Emirates; and Mumbai, India. The continuation of this process occurred with the opening of the Casablanca, Morocco office in April 2018. However, despite these efforts to gain a foothold abroad, we expect to see a shift in Lloyd's geographical strategy in the coming year. With Lloyd's engaged in an overhaul on profitability, Lloyd's leadership have indicated that the priority in the future is to maintain the Lloyd's presence in North America (the market that accounts for over half of the premiums each year) and in Europe post-Brexit. Though a handful of opinions in the market suggest that Lloyd's should be re-directing its attention to emerging markets with insurance-buying potential, the messaging from Lloyd's management reflects a contrary determination to ensure that efforts will largely be spent on keeping traction in established markets and developing products for use in those markets first.

Changes in leadership will also contribute to a busy upcoming year at Lloyd's focused on progress and profits. John Neal, former CEO of QBE Insurance Group Ltd., replaced Inga Beale as Lloyd's chief executive officer in September 2018. In his inaugural public speaking engagement on January 30, 2019, Mr. Neal discusses the recent struggling performance of Lloyd's in the past few years in the face of a changing marketplace and emphasizes the need to redirect Lloyd's back into the position of being a market leader with a view towards sustainable profitability. Mr. Neal has publicly suggested a combination of efforts will achieve this goal, including a focus on larger commoditized policies rather than niche areas, an emphasis on

established insurance markets rather than emerging markets, an increase in modernization and technological efficiency and a stripping of the worst-performing lines of business from syndicate business plans.

We expect to see the results of Lloyd's modernization plans come into greater view this year following the development of additional internal guidelines in the marketplace. Lloyd's issued a mandate requiring all brokers to connect to a recognized electronic placement platform by June 1, 2019, with the threat of de-registering brokers that do not comply. Further, Lloyd's established targets for each syndicate to have 40% of its risks written using a recognized electronic placement platform by the end of Q1 2019, that percentage to increase to 50% for Q2 2019. Lloyd's has also launched Lloyd's Bridge, an online platform that matches insurance business with underwriters from Lloyd's market to enable such businesses to underwrite policies on behalf of Lloyd's as Lloyd's coverholders. Modernization through the more widespread use of electronic placement systems will assist Lloyd's in becoming a more technologically advanced and cost-effective insurance platform in the marketplace, the result of which will allow it to compete more readily with the efficiency of traditional insurers.

Performance reviews that began in late 2018 with an eye towards profitability are also expected to continue through this year. Jon Hancock, Lloyd's performance management director, asked Lloyd's syndicates to identify and take action with respect to the lowest-performing 10% of their business, with the goal of ultimately remediating or eliminating those lines. In connection with this effort, Mr. Hancock emphasized that syndicate business plans predicting growth based on unrealistic pricing, distribution or ultimate profitability will receive push-back, including the possibility of demanding that syndicates exit underperforming classes of business with no indication of a return to profitability in the short term.

Another significant change taking place this year is Lloyd's new limit on the use of Solvency II Tier 2 capital as capital coverage. Lloyd's Market Bulletin Y5117, published on April 12, 2018, implements Lloyd's restrictions on all members' use of Tier 2 capital (which includes letters of credit, bank guarantees and life policies) lodged as members' Funds at Lloyd's. This mandate ultimately aims to limit each member's Tier 2 capital allowance as a proportion of its Funds at Lloyd's to 50% of its Economic Capital Assessment. This will take place in phases, with limits on Tier 2 capital usage capped at 90% from December 1, 2018 to November 30, 2019 and 70% from December 1, 2019 to November 30, 2020 before being capped at 50% from December 1, 2020.

Finally, Lloyd's announced in January 2019 that it is consulting on a proposed new approach to third-party oversight within the Lloyd's market—primarily focused on Lloyd's coverholders and third-party administrators (claims handlers)—with the latter now proposed to come directly within the scope of Lloyd's regulatory ambit. The stated purpose is to modernize Lloyd's current arrangements, help reduce compliance costs, reflect modern distribution methods and allow Lloyd's to take a more risk-based approach to oversight. This will be brought about through a changes to Lloyd's Intermediaries Byelaw and related requirements and its "Code of Practice - Delegated Authority." Lloyd's is also planning to replace its current ATLAS and

BAR systems with a new integrated, online compliance system: Chorus. Chorus is part of the London Market Target Operating Model program referred to in our update on Lloyd's last year.

### 3. Insurance Distribution Directive

On December 14, 2015, the European Council formally adopted the Insurance Distribution Directive (the "**IDD**"). The IDD replaces the Insurance Mediation Directive 2002/92/EC (the "**IMD**") and introduces 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 extended from February 23, 2018 to: (i) July 1, 2018 for transposition; and (ii) October 1, 2018 for application. This delay was brought about following calls from the European Parliament and member states to allow: (i) member states additional time to properly implement the new IDD regulatory framework; and (ii) the insurance industry more time to prepare for the IDD and the changes that will need to be made to comply with it. Accordingly, the IDD is now in force and applicable to all member states across the EU.

The IMD has been part of the EU regulatory landscape since January 14, 2005. An overhaul of the IMD provisions was prompted by: inconsistency in the way the IMD regime had been implemented by member states; development of a more complex insurance market and product offerings since the IMD was enacted; and a greater focus on consumer protection across all financial sectors since the 2008 financial crisis.

#### a. Summary of Key Changes Under the IDD

The IDD, like the IMD, is a minimum harmonization directive. This means that the IDD sets a threshold which national legislation must meet but, beyond which, member states are free to maintain or introduce stricter provisions relating to insurance selling. 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.

The impact of the extension of scope to insurers and reinsurers in the UK is not considered significant, as the UK had already "gold-plated" the IMD such that UK insurers and reinsurers directly selling to their customers were already in scope of the IMD. However, this change of scope is likely to have a more significant impact in other member states, where such entities were not subject to the IMD.

- **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. Such competency and continuing professional development requirements must match the complexity of the activities connected with the insurance product being sold and the type of distributor.

- **“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. Further, where a distributor advises on or proposes an insurance product which it did not manufacture, that distributor must have in place adequate arrangements to obtain the information it needs in order to understand the product characteristics and its identified target market.
- **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.

In the UK, the IDD’s remuneration provisions will principally impact brokers’ dealings with retail customers in the context of non-investment insurance contracts, as no such remuneration disclosure requirements under ICOBs applied under the IMD regime.

- **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.

Where the insurance product is the primary product with an ancillary non-insurance product or service, distributors must inform the customer whether it is possible to buy the different components separately. In addition, they must also: (i) provide an adequate description of the different components in the package; (ii) explain any interactions between the components; and (iii) provide information on the costs and charges of each component.

Where the insurance product is ancillary to a non-insurance product or service, the customer must be able to buy the non-insurance product or service separately.

- **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.

- **Ancillary Insurance Intermediaries (“AIIIs”).** The IDD introduces a new category of insurance intermediary, which are firms that meet the following requirements: (i) the firm’s principal professional activity is not insurance distribution; and (ii) the firm only distributes insurance products which are complementary to the goods and services they provide as their primary professional activity. In the UK, not all AIIIs will come within the scope of the IDD, and the FCA has chosen to apply different regimes depending on the type of AII concerned.

AIIIs can be categorized into the following three categories:

- **In-scope AIIIs.** In-scope AIIIs are firms that meet the above definition and are within the UK’s regulatory perimeter. Most of the requirements under the IDD will apply to these firms, although there is a slightly reduced information disclosure regime that is applicable to them.
- **Connected Travel Insurance Providers (“CTIs”).** CTIs are firms whose primary business is to make travel arrangements for customer, but who distribute insurance that is complementary to that service. Such firms were previously subject to a different regime under FSMA. Certain of the requirements under the IDD (including minimum PII levels, the employee training and development requirements and certain conduct of business requirements) will apply to CTIs.
- **Out-of-Scope AIIIs.** Out-of-scope AIIIs are firms outside the regulatory perimeter by virtue of the UK’s Connected Contracts Exclusion (Article 72B FSMA). Like for CTIs, a slightly more limited set of the IDD requirements will apply to such entities. These include ensuring there are appropriate and proportionate measures in place to comply with: (i) general conduct of business requirements (including acting honestly, fairly and professionally in the customer’s best interests, requirements relating to communications and restrictions on remuneration practices); (ii) the cross-selling rules; and (iii) considering the customer’s demands and needs.

## b. Developments in the Establishment of Delegated Acts, Technical Standards and Guidelines as Required Under 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 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 came into force in line with the IDD application date of October 1, 2018.

### c. How was the IDD Transposed Into UK Law?

HM Treasury worked with the PRA and the FCA to transpose the IDD into UK law.

#### i. HM Treasury

HM Treasury was responsible for the actual transposition of the IDD into UK law, which it completed through the Insurance Distribution (Regulated Activities and Miscellaneous Amendments) Order 2018 (the "**Order**"). The Order amended a number of pieces of existing legislation including various provisions in FSMA. The Order was laid in Parliament on April 30, 2018 and came into force on October 1, 2018.

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, the Order makes the following amendments (among others) to legislation to implement the IDD:

- **Article 33B of the RAO.** Introducing a new Article 33B of the RAO, which sets out an exclusion to the "arranging deals in investments" regulated activity. This exclusion relates to the provision of specified information where no other steps are taken by the intermediary to conclude the contract.
- **Part 13A in FSMA.** Including a new Part 13A in FSMA which allows the appropriate regulator to exercise its powers of intervention in relation to EEA firms passporting into the UK and to allow enhanced supervision in accordance with Article 7 of IDD.
- **137R of FSMA.** Amending Article 137R of FSMA to allow the FCA to make financial promotion rules in line with Article 17 of IDD.

#### ii. FCA and PRA

The FCA has made 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 were published in the FCA's Insurance Distribution Directive Instrument 2018 (FCA 2018/25) (the "**IDD Rules**"), which was made on May 24, 2018 and came into force on October 1, 2018. 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 ahead of their formal application.

Similarly to the proposed legislative changes, the FCA's approach to implementing the IDD was to build on the rules and guidance already in place. In general, the FCA has introduced the minimum IDD standard through an intelligent copy-out of the rules in the IDD, however, in some places it has "gold-plated" the minimum standards where it was deemed appropriate. In addition, 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, as the IMD version of the Handbook already covered, to a greater or lesser extent, many of the requirements under the IDD. That being said, firms still need to familiarize themselves with the Handbook changes to ensure that they are compliant now that these rules are applicable to them.

The PRA has only made minor, administrative changes to the PRA Rulebook, to reflect the implementation of the IDD.

#### d. Next Steps

Now that the IDD is in force and applicable to distributors in the UK, such firms are subject to its rules and requirements. There is still considerable uncertainty in relation to Brexit, although we note that it is proposed that all European legislation that has already been implemented in the UK, will remain in force following the UK's withdrawal from the EU. Accordingly, distributors in the UK can expect to continue to be subject to the provisions of the IDD, even once the UK has left the EU. In fact, The Insurance Distribution (Amendment) (EU Exit) Regulations 2019 were published on 21 November 2018 and are due to be laid before parliament prior to March 29, 2019. These regulations will in effect convert the IDD as currently implemented into UK domestic law subject to certain necessary amendments. For further information on this, please see section IV.C.3.

### 4. SM&CR Extended to Insurers

On December 10, 2018, the SM&CR came into effect for insurers, replacing both the PRA's Senior Insurance Managers Regime ("**SIMR**") and the FCA's Approved Persons Regime ("**APR**"). Originally in force for banks, building societies, credit unions and PRA-designated investment firms since March 2016, the SM&CR has been extended to insurers with the aim of strengthening individual accountability across the financial sector.

### 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, incoming branches of non-UK firms, and large non-directive firms<sup>11</sup> ("NDFs")). A streamlined set of requirements will apply to small run-off firms, small NDFs<sup>12</sup> and ISPVs. The FCA has confirmed that the regime will be extended to insurance intermediaries with effect from December 9, 2019.

There is a strong theme from both regulators that accountability and governance are the main drivers behind the extension of the regime. From the PRA's perspective, the intent of the SM&CR is "to facilitate a clear identification and allocation of responsibilities to the individuals responsible for running firms, to promote firms' safety and soundness and enhance policyholder protection. The SM&CR provides a framework to encourage individuals to take greater responsibility for their actions, and make it easier for firms and regulators to hold individuals to account."

The SM&CR applies to individuals who perform Senior Management Functions ("SMF"). An SMF is defined in section 59ZA of FSMA as: "in relation to the carrying on of a regulated activity [by a firm], ... [a] function [that] will require the person performing it to be responsible for managing one or more aspects of the [firm's] affairs, so far as relating to the activity, and ... those aspects involve, or might involve, a risk of serious consequences ... for the [firm], or ... for business or other interests in the United Kingdom."

Senior managers are the most senior people in a firm with the greatest potential to cause harm or impact upon market integrity. The PRA and the FCA have each designated a list of roles which correlate to a particular function. In order to perform an SMF, the individual will need to be pre-approved by the relevant regulator.

Although the previous regime, the SIMR, already incorporated some of the substantive ideas and principles of the SM&CR, such as the pre-approval process for specified functions, 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 section 66B(5) FSMA, the regulators are empowered to take action for misconduct against an individual if:

- **Senior Manager.** The individual has at any time performed as a "senior manager" at a firm;
- **Contravention.** The firm contravenes, or has contravened, a regulatory requirement;
- **Responsibility.** 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

- **Reasonable Steps Criterion.** 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 "**Reasonable Steps Criterion**").

In its July 2018 Supervisory Statement, titled "Strengthening individual accountability in insurance," the PRA has set out its approach to the Reasonable Steps Criterion, which involves the PRA assessing (a) the steps that the specific Senior Manager actually took, against (b) such steps as the PRA considers that a Senior Manager, in that position, could reasonably have been expected to take to avoid the contravention occurring (or continuing). The PRA's expectations of the steps in "(b)" will necessarily depend on the circumstances as they existed at the time. In forming its view of "(b)", the PRA has set out some examples of factors it may consider, such as:

- The size, scale and complexity of the firm;
- What expertise and competence the senior manager had, or ought to have possessed, at the time to perform their specific SMF; and
- The overall circumstances and environment at the firm and more widely, in which the senior manager was operating at the time.

In relation to "(a)" and the steps that a senior manager actually took to avoid the contravention occurring or continuing, examples of the steps that might be considered to be reasonable actions, depending on the circumstances, could include:

- Pre-emptive actions to prevent a breach occurring, including any initial reviews of the business or business area on taking up an SMF;
- Implementing, policing and reviewing appropriate policies and procedures; and
- Awareness of relevant requirements and standards of the regulatory system.

### c. Certification Regime

The extension of the Certification Regime to insurers is an additional layer of regulation and administration with which insurers will have to comply. The PRA has defined "certification functions" as:

- **Key Function Holder ("KFH").** A function performed for a firm by a KFH at the firm; and
- **Material Risk Taker.** A function performed by a "material risk taker" (i.e., those employees whose professional activities have a material impact on the firm's risk profile) at a "large firm."<sup>13</sup>

<sup>11</sup> Firms outside the scope of Solvency II.

<sup>12</sup> A "small NDF" is a firm where the value of assets for all the regulated activities it carries out is £25 million or less.

<sup>13</sup> A "large firm" is a firm with gross written premiums of more than £1 billion in each of the previous three financial years or with assets related to all regulatory activities carried on by the firm of more than £10 billion at the end of each of the last three financial years.

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. 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; operational systems and control; and those managing material risk takers.

The FCA's Certification Regime is wider than that of the PRA and may include individuals who are not in scope of the PRA's regime. Insurers must check that the relevant employees are being captured to comply with the requirements of both regulators, although it is worth noting that some of the FCA's certification functions may not be relevant for insurers.

In terms of timing, firms will not be required to certify employees performing certification functions as fit and proper until December 10, 2019.

#### d. Conduct Rules

Under the previous regime, individuals performing controlled functions, KFHs and any person performing a key function were required to adhere to certain conduct standards. The new regime extends the application of these rules to all employees performing a "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 "certification functions" will need to have already received training. However, for other individuals, firms will have 12 months from the commencement date to provide the requisite training.

In addition, the regulators have introduced notification requirements for firms where they take disciplinary action against individuals for conduct rule breaches. "Disciplinary action" is defined in FSMA as meaning any of the following: the issuing of a formal written warning; the suspension or dismissal of the person; the reduction or recovery of any of the person's remuneration. The new notification requirement does not change or remove the firm's obligations to report concerns about an individual's conduct under existing regulatory rules, but is intended to complement them.

#### e. Senior Managers Regime

More broadly, some of the terminology with which insurers were 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 has been renamed

"statement of responsibilities" and governance maps have been renamed "management responsibilities maps." Separately, the regulators have added a new rule with regard to the handover of responsibilities which requires 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. Impact on Insurers

Although the new regime is now almost fully in place, as noted above, firms still have until December 10, 2019 to certify employees performing certification functions as fit and proper. In the meantime, insurers are getting to grips with a regulatory framework that is broader and places more responsibility on individual behavior and accountability.

### 5. EU and Member State Competition Law Enforcement Activity

2018 was a period of increased enforcement activity by the Commission, the Court of Justice of the EU ("**CJEU**") and the General Court of the EU ("**General Court**") (together, "**EU Courts**"), and by national competition authorities in the EU.

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

##### i. European Commission

Following its dawn raids in July 2017, the Commission continued its investigation into the allegedly anticompetitive conduct of certain automotive insurers in Ireland. In January 2018, the Irish Competition Authority announced that it had obtained 1.25 million emails and other internal documents in its separate investigation of the sector. Trade association Insurance Ireland issued a public statement in May 2018 denying allegations that it unlawfully excluded potential members, and in December 2018, the EU's Competition Commissioner confirmed, in response to questions from the European Parliament, that the Commission's analysis of the evidence is ongoing.

In May 2018, the Commission proposed amendments to the EU Motor Insurance Directive (2009/103/EC), which facilitates intra-EU trade by extending the motor insurance coverage of EU residents when traveling in another EU member state. If adopted, the amendments will (i) provide for compensation following an insurer's insolvency; (ii) harmonize minimum levels of coverage; (iii) expand EU member states' powers to conduct insurance checks; (iv) codify existing case law in relation to private land; and (v) prohibit discriminatory treatment, on grounds of nationality, in respect of claims history statements in order to facilitate customer switching.

In December 2018, the Commission extended its decision, following consultations in March and October, to consider short-term export-credit risks towards Greece as temporarily "non-marketable" through 2019. Export-credits enable exporters established in a given EU member state to insure their receivables against the commercial and political risks attendant on sales to customers established outside the EU member state. The Commission has decided that insurance cover

for exports to Greece remains unavailable in the private market and so may temporarily be supplied, without constituting unlawful State aid, by the EU member states.

## ii. EU Courts

Following a hearing in April 2017, the General Court delivered a judgment in February 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.

In February 2018, the CJEU delivered a preliminary ruling in relation to tenders submitted by insurers in the context of public procurement. The case, which was referred by an Italian court, concerned the automatic exclusion of multiple tenders submitted by Lloyd's syndicates in the same call for tenders, on the basis that 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.

In November 2018, the CJEU's Advocate General Wahl delivered an Opinion concerning the principle of *ne bis in idem* in relation to the fines imposed on a Warsaw-based insurer for its alleged abuse of a dominant position. The non-binding Opinion concludes that EU competition law did not preclude the Polish Competition Authority from imposing concurrent fines in relation to breaches of Polish competition law and, following Poland's accession to the EU, EU competition law. However, the Opinion also invited the CJEU to re-evaluate the principle's limited application in competition proceedings. The CJEU's judgment is expected in early 2019.

## b. National Level Enforcement in the UK

### i. PRA Affirms Role of Its Secondary Competition Objective in Implementing Solvency II

In January 2018, the UK Parliament's Treasury Select Committee published the initial response of the PRA to the Committee's report "Solvency II Directive and Its Impact on the UK Insurance Industry." The PRA affirmed the importance of prudential regulation to facilitate effective competition in insurance markets, and published its full report in February 2018.

### ii. Competition and Markets Authority Issues Legal Orders Against Barclays Bank and Lloyds Bank for PPI Failures

In August 2018, the Competition and Markets Authority ("**CMA**") issued legal directions to Barclays Bank for its failure to send PPI customers an annual reminder in relation to their premiums and cancellation rights. In October 2018, the CMA sent similar such

directions to Lloyds Bank, which had also provided certain customers with incorrect information. The CMA directed the banks to take remedial action.

### iii. CMA Responds to Super Complaint Regarding "Loyalty Penalties"

In September 2018, Citizens Advice, a designated consumer body under the Enterprise Act 2002, submitted a "super complaint" to the CMA in respect of the loyalty penalties which Citizens Advice alleged were charged in five sectors, including household insurance. The CMA has welcomed the FCA's market study (see section IV.C.5.b.v below) and recommended possible pricing interventions.

### iv. CMA Investigates Most Favored Nation Clauses Used by ComparetheMarket

In September 2018, the CMA announced that it had taken enforcement action against a number of online hotel booking websites, and, in November 2018, sent a statement of objections to ComparetheMarket in connection with its use of contractual terms that the CMA considers may prevent home insurers from offering lower prices on rival websites and other sales channels.

### v. FCA Launches Market Study Into General Insurance Pricing Practices

In October 2018, the FCA launched a market study into the pricing of general insurance ("**GI**") firms in respect of new and existing customers for home and motor insurance, in conjunction with its discussion paper, titled "Fair Pricing in Financial Services." The FCA's interim report is scheduled for publication in summer 2019, with the final report due by the year's end.

### vi. CMA Concludes Market Investigation Into Investment Consultancy and Fiduciary Management Services

In December 2018, the CMA published its final report on its market investigation into investment consultancy and fiduciary management services. The CMA concluded that accessing and assessing the information needed to evaluate such services may contribute to low levels of switching by pension scheme trustees, and will consult on its proposed remedies in Q1 2019.

### vii. CMA Reviews PPI Market Investigation Order 2011

In December 2018, the CMA concluded a review of the PPI Market Investigation Order 2011, which followed an earlier market investigation into the sector and prescribes the information which insurers must provide to policy holders annually (see section IV.C.5.b.ii above). The CMA's amendments follow the UK's transposition of the Insurance Distribution Directive ((EU) 2016/98) in October 2018.

### viii. FCA Opens Consultation on GI Value Measures

In January 2019, the FCA opened a consultation on a proposal to require firms to report data relating to their GI value measures for publication by the FCA, following the finding of its GI add-ons market

study that a lack of common value measures may contribute to ineffective competition in the sector. The consultation will run through April 2019.

#### ix. FCA Publishes Final Report in Wholesale Insurance Broker Market Study

In February 2019, the FCA published the final report in its wholesale insurance broker market study, first launched in November 2017 in order to examine the use of market power by brokers and the management of conflicts of interest. The FCA concluded that the limited concerns identified in the market study could be addressed through its ordinary supervisory process.

#### c. National Level Enforcement in Austria

In May 2018, Austria's competition authority, the Bundeswettbewerbsbehörde ("**BWB**"), published the first interim report of its healthcare sector inquiry. The BWB is examining the supply of health insurance, pharmaceutical and hospital services, and patient transport, and has recommended a series of deregulatory measures to lower the costs to health insurance funds.

#### d. National Level Enforcement in Bulgaria

In August 2018, Bulgaria's Commission for the Protection of Competition ("**CPC**") suspended a tender procedure, run by the State-owned railway company BDZ, for the provision of insurance services to its rolling stock and properties. The suspension followed a complaint by OZK Insurance that the effect of BDZ's tender criteria was to exclude all but two insurers active in the segment.

#### e. National Level Enforcement in Denmark

In August 2018, Danish pension fund Danica Pension announced that it had applied for leniency to Denmark's Competition and Consumer Authority, the Konkurrence- og Forbrugerstyrelsen, in respect of possible competition law breaches which an internal review of its joint bidding identified. The State Prosecutor for Serious Economic and International Crime is also investigating.

#### f. National Level Enforcement in Finland

In February 2019, the Finnish Competition and Consumer Agency ("**KKV**") announced that it had closed an investigation into an alleged abuse of dominance by Finnish insurer OP Group. The complaint which had led to the KKV's investigation concerned a loyalty bonus which the OP Group paid to customers of its insurance business who also purchased one its mortgage products.

#### g. National Level Enforcement in France

In February 2018, the Paris Court of Appeal dismissed an appeal against the decision of the French Competition Authority, the Autorité de la Concurrence, to reject a complaint against healthcare insurer Santéclair concerning its recommendations of particular medical professionals. The court held that Santéclair had not excluded any such professionals who wished to join its network.

#### h. National Level Enforcement in Germany

In April 2018, the German Federal Cartel Office ("**FCO**") confirmed its receipt of a complaint alleging anticompetitive collusion among the members of the German health insurers' association PKV; and in December 2018, the FCO presented the results of its sector inquiry into online comparison websites, including those in the insurance sector. A final report is due later in 2019.

#### i. National Level Enforcement in Greece

In February 2018, the Hellenic Competition Commission ("**HCC**") decided that Audatex Hellas, a joint venture among four automotive insurers, had not agreed to fix hourly rates for repair services via the joint venture's software. The HCC concluded that the repair estimates generated by the software on the basis of repair shops' actual costs were mere recommendations to the insurers.

#### j. National Level Enforcement in Hungary

In April 2018, the Hungarian Ministry of National Development called on the Hungarian Competition Authority, the Gazdasági Versenyhivatal ("**GVH**"), to investigate the automotive insurance sector. Earlier, in January 2018, the GVH accepted commitments from Generali, Allianz, and an insurance broker of Peugeot dealers to end an investigation into vehicle repair fees.

#### k. National Level Enforcement in Italy

In June 2018, Italy's competition authority, the Autorità Garante della Concorrenza e del Mercato, published the findings of the first phase of its sector inquiry into Big Data, which examined the competitive effects of "over-the-top" services in several sectors, including insurance. The second investigative phase, examining market power and mergers, commenced in June 2018.

#### l. National Level Enforcement in Netherlands

In July 2018, the Dutch competition authority, the Autoriteit Consument en Markt ("**ACM**"), announced the opening of a Phase II investigation into a proposed merger between the two largest independent healthcare centers in the Netherlands, following complaints by insurers. In December 2018, however, the ACM concluded that the overlaps would be limited and cleared the deal.

#### m. National Level Enforcement in Poland

In June 2018, Poland's Office of Competition and Consumer Protection ("**UOKiK**") announced that it would close its investigation into the automotive insurance sector, citing an absence of evidence of collusion. Instead, the UOKiK reported that the price increases which it had observed were attributable to rising costs, and deteriorating financial results, among insurers.

#### n. National Level Enforcement in Portugal

In August 2018, Portugal's competition authority, the Autoridade de Concorrência ("**AdC**"), sent a statement of objections to five insurers alleged to have cartelized multiple insurance sectors. In December 2018, Fidelidade and Multicare settled, and in February 2019, the AdC announced that Seguradoras Unidas had received immunity. Zurich and Lusitania remain under investigation.

#### o. National Level Enforcement in Romania

In December 2018, the Romania's competition authority, the Consiliul Concurenței ("**CC**"), imposed fines totaling €53 million on nine automotive insurers for exchanging commercially sensitive information concerning their intended premium increases. Euroins, which had supplied significant information to the CC, received a reduced fine. Multiple parties have appealed.

#### p. National Level Enforcement in Sweden

In July 2018, Sweden's competition authority, the Konkursverket, published a recommendation to expand access to online price comparison websites for veterinary insurance, following increases in insurance premiums described as "dramatic" in some segments, and to introduce associated amendments to the Consumer Services Act concerning consumer redress.

In November 2018, the Swedish Supreme Court dismissed an appeal by insurance broker Söderberg & Partners in relation to a dawn raid conducted by the Konkursverket. It held that while the broker might be able to seek financial compensation, the enforcement measures cannot be challenged in Swedish courts directly, but only indirectly after a prior administrative review.

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

The EU's General Data Protection Regulation 2016/679 ("**GDPR**") entered into force on May 25, 2018, introducing a number of new requirements that have a significant, and sometimes onerous, impact on (re)insurance companies. In turn, national laws implementing the GDPR have to date been enacted in 23 EU member states, with draft Bills published in the other five EU member states.

While the GDPR includes over 50 instances where member states may introduce national derogations, the overall intention of the GDPR was to create a harmonized approach to data protection compliance across the EU. As member states have started to publish guidance and implement national legislation it has become clear that this is not going to be the case.

#### a. Brexit

The UK has implemented the GDPR into domestic legislation via the UK's Data Protection Act 2018 ("**DPA 2018**"). In anticipation of the UK's scheduled departure from the EU on March 29, 2019, the UK government has introduced the draft Data Protection, Privacy and Electronic Regulations 2019 ("**Draft Regulations**"), which amend the DPA 2018 to ensure UK data protection law functions effectively post-Brexit (see section IV.C.1 for further information regarding Brexit). For example, the Draft Regulations replace references to EU member states and EU institutions, practices and procedures that will no longer be directly relevant to UK data protection law post-Brexit, with UK equivalents. Further, references to the GDPR have been amended to refer to the UK GDPR and references to obligations of the UK Information Commissioner's Office (ICO) to cooperate with other member state Data Protection Authorities ("**DPA**s") have been revoked.

The Draft Regulations also maintain the extra-territorial application of the GDPR for the UK. As such, controllers and processors established outside of the UK who are processing the personal data of individuals in the UK for the purposes of providing goods or services to, or monitoring the behavior of, individuals in the UK will be subject to the UK GDPR. The Draft Regulations also impose a requirement for companies (including (re)insurance companies), outside of the UK who are subject to the UK GDPR by virtue of its extra-territorial application, to appoint a data protection representative in the UK, (i.e., in line with Article 27 of the GDPR). To the extent there is a "no deal" Brexit (see section IV.C.1.d for further information) the requirement to appoint a UK data protection representative would extend to companies in the EU.

Some of the key provisions of the GDPR that are of particular relevance for the (re)insurance industry are summarized below.

#### b. 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, DPAs 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 is 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 ongoing compliance.

As at January 2019, the DPAs had initiated 255 investigations in the context of EU cross-border processing activities, of which the majority were in response to individual complaints. As at mid-February 2019, three fines have been issued under the GDPR. In particular, the French DPA issued a fine of €50 million against Google for violations of the GDPR's transparency and consent requirements.

#### c. Application to Non-European Businesses

The GDPR applies to companies established in the EEA/UK, as well as to companies based outside the EEA/UK that process personal data of individuals in the EEA/UK, where the processing is related to the offering of goods or services to, or the monitoring of the behavior of, individuals in the EEA/UK.

Therefore, if a U.S. or other non-EEA/UK (re)insurer underwrites risk for, or issues policies to, individuals in the EEA/UK, or they monitor an insured's behavior in the EEA/UK, 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 the GDPR and therefore, such organizations should, if they have not already done so, review their data processing policies and protections to ensure GDPR compliance.

#### d. One-Stop-Shop

A “one-stop-shop” mechanism operates under the GDPR where businesses carrying out “cross-border processing” will ordinarily be accountable to one single lead DPA (“**Lead DPA**”) in the EEA country where the 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 European Data Protection Board (“**EDPB**”), the EU-wide data supervisory authority, which will issue a binding opinion. In exceptional circumstances, a “concerned” DPA can adopt provisional measures and request an urgent opinion from the EDPB. The one-stop-shop mechanism may be beneficial to (re)insurance companies that operate across the EEA, as in theory, they would only have to report to and deal with the Lead DPA for data protection issues that affect their cross-border operations. The EDPB 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., where a company is based in the U.S.), the one-stop-shop mechanism 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.

#### e. Controllers and Processors

The GDPR distinguishes between “controllers” and “processors.” With respect to the (re)insurance industry, it is likely that (re)insurance companies will be treated as controllers. This is on the basis that, for example, (re)insurance companies, in many circumstances, determine what data of their customers and employees are to be collected, and for what purposes this data are to be used. As a result of being classified as a controller (relative to being classified as a processor), (re)insurance companies are responsible for complying with the majority of the obligations under the GDPR.

As a controller, (re)insurance companies will need to ensure that where they engage a vendor (acting as a processor) to process personal data on their behalf (e.g., to process claims), appropriate contractual provisions are in place as required under the GDPR.

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 is extremely important, and contracts between controllers and processors will need to take this into account, as well as mechanisms to resolve any disputes.

#### f. Notice and Consent

The GDPR imposes a high threshold for obtaining valid consent to process personal data, and consent must be freely given, informed, clear and affirmative, i.e., rather than implicit and tacit. (Re)insurance companies should therefore consider, where possible, relying on an alternative legal ground, such as legitimate interest or compliance with a legal obligation where personal data is not sensitive. Where consent is the only valid legal ground (e.g., for direct marketing),

controllers will need to be able to demonstrate that they have received valid consent from a particular individual. This could be problematic for (re)insurance companies, as (re)insurance companies tend not to have any direct relationship 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 ensure their contracts with intermediaries impose such obligations. In addition, individuals have a right under the GDPR to be informed about the collection and use of their personal data. Again, where there is no direct interaction with the data subject, it may be necessary for (re)insurance companies to discharge this obligation contractually with the relevant third party. However, even in such cases, the (re)insurance company will need to consider how it can demonstrate that a valid information notice has in fact been provided to data subjects.

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.

#### g. Data Protection Officer

Controllers and processors are required under the GDPR to appoint a data protection officer (“**DPO**”) where: (i) the core activities of the company consist of processing operations that require regular and systematic monitoring of data subjects on a large scale; or (ii) the core activities of the company consist of processing special categories of personal data (e.g., health data) or personal data relating to criminal convictions or offenses, on a large scale. (Re)insurance companies for example, in the life or motors’ industries, will in particular need to consider the requirement to appoint a DPO.

#### h. Accountability

A key focus of the GDPR is the principle of accountability, including, for example, 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 data (e.g., health data) on a large scale or systematically monitoring a publicly 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 to individuals. As much of the personal data held by (re)insurance companies would be considered sensitive 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.

### **i. Information Security and Breach Notification**

All organizations must implement appropriate technical and organizational security measures, particularly if sensitive 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, 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 controller becomes aware of the security breach. Given that (re)insurance companies, particularly life (re)insurance companies, process a considerable amount of sensitive data about individuals, such organizations are an attractive target for hackers. Therefore, (re)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 and appropriate incident response plans. Such plans should be regularly tested with training for employees, such as through hypothetical table-top cybersecurity exercises.

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.

### **j. Increased Rights of Individuals**

Consumer awareness in relation to privacy issues appears to have dramatically increased, in particular, the fact that consumers can exercise their rights under the GDPR. This is illustrated by the fact that between May 2018 and January 2019, there were 95,180 complaints lodged with EU DPAs and 41,502 data breaches were notified to DPAs.

Two of the more controversial rights 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 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. 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 should consider 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, and such considerations should be built into guidelines on

how to respond to such requests. (Re)insurance companies should 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 controllers (when the controller is processing based on consent or the performance of a contract), so that they can transfer their personal 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 published by the EDPB, 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 preserve the precise meaning of exchanged information. This could be problematic for (re)insurers and their intermediaries, as many hold personal data on different systems depending on the stage at which the personal 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 (re)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 (re)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 EDPB, and therefore, in order to mitigate the impact of this new right, the (re)insurance industry should consider developing strategies to determine how they will deal with it.

### **k. Profiling**

The GDPR imposes restrictions on 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 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.

This right will have a significant 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.

## I. Transfer of Personal Data from the EEA/UK

The GDPR prohibits the transfer of personal data to countries outside the EEA that are not considered to have an adequate level of protection, such as the U.S., unless: (i) the recipient country is considered to offer an adequate level of data protection (e.g., Japan); (ii) a data protection safeguard has been applied (such as the EU's Standard Contractual Clauses for transfers of personal data from the EU—also known as “Model Contracts”—or the organization has implemented Binding Corporate Rules) or (iii) a derogation from the prohibition applies (such as the data subject having explicitly consented to the transfer).

In the event of a “no deal” Brexit (see section IV.C.1.d above for further information), a valid international data transfer solution will need to be put in place in order to legitimize transfers of personal data from the EU to the UK (e.g., Model Contracts). In the long term, the UK is hoping for an adequacy decision from the European Commission to permit the free-flow of personal data from the EU to the UK post-Brexit. However, the UK is unlikely to be prioritized in this regard in the event of a “no-deal” Brexit. Importantly, the UK Government has confirmed that no restrictions will be put in place for the transfer of personal data from the UK to the EU. However, as is the case currently, post-Brexit transfers of personal data from the UK to outside of the EEA will still require a valid international data transfer solution.

### m. Final Thoughts

The GDPR has had a significant impact on the way in which the (re) insurance industry processes personal data with companies having to make a large number of policy and other administrative changes, which in turn, has been costly. Further, as compliance with the GDPR is an ongoing requirement, the (re)insurance industry will need to continue its efforts to achieve compliance (whether in the form of policy, procedural, technological or other changes) as 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 industry to implement improved cybersecurity measures. Highlighted below are recent regulatory developments in the insurance industry 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.

## 1. State Adoption of Insurance Data Security Model Law

In October 2017, the NAIC adopted the Insurance Data Security Model Law (the “**IDS Model Law**”). 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 V.A.2 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:

- **Due Diligence.** 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;
- **Cybersecurity Program.** 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);
- **Notice to State Insurance Department.** 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
- **Health Insurance Portability and Accountability Act of 1996 (“HIPAA”) Exemption.** Unlike the NY Cybersecurity Regulation, the IDS Model Law includes an exemption for entities that have complied with data security requirements under HIPAA.

In May 2018, South Carolina Governor Henry McMaster signed into law the South Carolina Insurance Data Security Act (the “**South Carolina Act**”), which is modeled after the IDS Model Law. The South Carolina Act became effective January 1, 2019 and by July 1, 2019 licensees must establish a comprehensive, written information security program (which is to become effective no later than July 1, 2020). Beginning on February 15, 2020, each insurer domiciled in South Carolina must annually submit to the Director of the South Carolina Department of Insurance a written statement certifying that the insurer is in compliance with the requirements set forth in the South Carolina Act.

In December 2018, Michigan joined South Carolina as the second state to adopt a law modeled after the IDS Model Law. Licensees have until January 20, 2022 to implement the provisions of their respective written information security programs.

## 2. Implementation of the NY Cybersecurity Regulation

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.

Beginning on February 15, 2018, Covered Entities were required to comply with other obligations of the NY Cybersecurity Regulation, including: (i) adopting a formal written cybersecurity program, (ii) limiting/restricting access privileges to information systems that provide access to nonpublic information, (iii) having cybersecurity personnel (internally or through qualified third-party providers), (iv) designating a chief information security officer, (v) having a written incident response plan and (vi) filing a certificate of compliance with the NYDFS.

Beginning on March 1, 2018, Covered Entities were required to comply with additional obligations of the NY Cybersecurity Regulation (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 by September 4, 2018, Covered Entities were required to have in place certain additional safeguards:

- **Audit Trail.** An audit trail that shows detection of and response to material cybersecurity events;
- **Security Procedures.** Written security procedures, guidelines and standards for the development of in-house applications and for the evaluation and testing of externally developed applications;
- **Data Retention Policies.** Data retention policies and procedures for the disposal on a periodic basis of nonpublic information no longer necessary for business operations;
- **Risk-Based Policies.** Risk-based policies, procedures and controls to monitor the activity of authorized users and detect unauthorized access; and security controls, such as encryption, to protect non-public business relations and personal information.

The final compliance deadline for Covered Entities under the NY Cybersecurity Regulation was March 1, 2019, by which time Covered Entities must have security policies in place that govern the security of third-party service providers and, by that deadline, must have implemented their respective written security policies.

## B. UK AND EUROPE

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 requires not

only a review of a firm’s own cyber underwriting risk, but also, as a financial services firm holding valuable data, maintenance of effective cybersecurity.

### 1. PRA Communication

On January 30, 2019, the PRA published a Dear CEO letter to chief executives of specialist general insurance firms regulated by the PRA on the management of cyber insurance underwriting risk. The letter followed a supervisory statement (SS4/17) issued by the PRA in July 2017, in which it set out its expectations for the management of cyber insurance underwriting risk. Cyber underwriting risk is defined in the supervisory 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.”

In May 2018, the PRA, after discussions with industry associations and Lloyd’s, carried out a follow-up survey involving firms of varying sizes. The Dear CEO letter provides feedback on the key themes that emerged from firms’ responses and areas where the regulator thinks that firms can do more to prudently manage their cyber risk exposures.

### 2. Non-Affirmative Cyber Risk<sup>14</sup>

Some high-level thematic findings demonstrated that almost all firms agreed that a number of traditional lines of business have considerable exposure to non-affirmative cyber risk. The largest exposure were noted to be in the casualty, financial, motor and A&H lines. The results also showed that firms’ quantitative assessments of non-affirmative risk are not well-developed and mostly rely on stress scenarios. Firms with the most developed approach had conducted detailed analyses and established processes for capturing cyber exposures for all products by considering various parts of an organization, for example, underwriting, claims, risk, IT and actuarial. This often included reviews of policy wording and exclusions. It also highlighted that some firms still need to do more to accurately assess the risk they may face in this area.

Some firms assessed the potential risk of loss from cyber events as being equivalent to major natural catastrophes in the U.S. This of course has reinforced the PRA’s concerns about large potential exposures and emphasized that firms need to ensure that they manage unintended exposure to this type of risk.

### 3. Affirmative Cyber Risk<sup>15</sup>

The survey results also indicated a significant widening of cover for cyber insurance products. Although the PRA recognizes that broader cover is beneficial for policyholders, there is clearly a prudential risk for insurers if not considered alongside appropriate pricing

<sup>14</sup> Insurance policies that do not specifically include or exclude coverage for cyber risk, also referred to as “silent” cyber risk.

<sup>15</sup> Insurance policies that explicitly include coverage for cyber risk.

adjustments and suitable risk management, given the immaturity of the cyber market compared to more established risk areas and the resultant lack of available data.

The PRA also noted that there are instances where cyber limits are significant when weighed against the relatively low premium volume and the dearth of claims experience.

In order to understand some of these issues, the PRA will initiate an exploratory cyber stress test: the PRA's 2019 General Insurance Stress Test. Details of this will be published later in the year.

#### 4. Cyber Risk Strategy and Risk Appetite

Although firms acknowledged the need to have formalized risk appetites and a board-agreed strategy for both affirmative and non-affirmative risk, survey responses indicated that progress has been varied, with the focus primarily on affirmative cyber risk. Firms have reported using available cyber scenarios along with catastrophe cyber risk models to inform their risk appetites, with the most developed firms creating bespoke scenarios which may better reflect their own underlying exposure.

Limited progress has been made on developing management information for the board, with the focus mainly on affirmative cyber risk where firms compare exposure against scenarios and risk appetites. Firms need to do more to meet the PRA's expectation in this area.

#### 5. Cyber Expertise

There is recognition from firms that their knowledge must be developed further in order to keep up with the evolving nature of cyber risk. Firms are making use of external expertise (such as catastrophe modeling vendors and consultants) in conjunction with bespoke training programs for board members and underwriters, with some firms even creating internal "centers of excellence" to improve the distribution of cyber knowledge and risk management.

#### 6. Next Steps

Although the survey results suggest some work has been done, further work is necessary especially in relation to non-affirmative cyber risk management, risk appetite and strategy. The main obstacles to the prudential management of cyber underwriting risk were reported by firms as being: challenging market conditions; broker pressure; and lack of historic data, models and expertise. Despite these challenges, the PRA remains of the view that its expectations set out in supervisory statement SS4/17 are relevant and valid and that firms should progress their initiatives to fully align with these expectations.

Going forward, the PRA is looking to provide further, targeted feedback to surveyed firms, with the aim of meeting with each surveyed firm by the end of Q1 2019. Moreover, they are looking to coordinate with Lloyd's to agree any follow-up actions in relation to Lloyd's managing agents, while also carrying out sample deep-dive reviews to other firms in the latter half of 2019 to assess how these firms are meeting the expectations laid out in SS4/17.

Also, insurers are to develop an action plan by the first half of 2019 with clear milestones in relation to ways in which such firms will reduce their unintended exposure to non-affirmative cyber risk.

#### 7. FCA Speech on Cyber and Technology

While the PRA's focus is on firms managing their cyber underwriting risk, the FCA's goal is to help firms to become more resilient to cyber attacks. In November 2018, the FCA gave a speech on "Cyber and technology resilience in UK financial services" on how well UK financial services are managing risks associated with new technology. The assessment was based on a survey that nearly 300 firms completed between 2017 and 2018.

From January to October 2018, firms reported a 187% increase in technology outages to the FCA, 18% of which were cyber-related. The objective of the FCA is not to prevent any incidents occurring, the intention is to determine how well such incidents are managed. Therefore, from the FCA's perspective, in order to understand firms' cyber resilience, it asks questions such as: Are firms operating strong lines of defense? Are firms resolving issues swiftly? Are firms responding to emerging threats? Are firms managing third parties effectively?

One of the key themes of the FCA's speech is risk management. The FCA is concerned that firms are unduly confident about their ability to update their systems and manage IT changes. In order to address the weaknesses in "change management," firms need Board-level knowledge, in-house capability and high quality management information. In reality, most firms do not operate in this way and tend to outsource the IT functionality. The FCA is happy for firms to do deal with its technology issues in the way that it sees fit as long as it allows firms to demonstrate that their systems and controls work. However, the regulator has observed that the most effective management of risk takes place at firms that use the long-established "three lines of defense" model.

Another key theme in the FCA's speech is cyber resilience. Cyber attacks are as prevalent as ever, therefore, it is worrying that the FCA is seeing serious vulnerabilities in areas like identification of key assets, information and detection. The regulator states that "a third of firms do not perform regular cyber assessments. Nearly half of firms do not upgrade or retire old IT systems in time. And only the largest firms have automated their detection systems to spot potential cyber attacks."

The improvement of systems and controls can help to prevent cyber attacks. However, cyber risk is not just a technology issue, it is a human risk. Noting that computer output is neutral, problems occur because of the people using them, whether intentionally or not. Educating and supporting staff in cyber awareness is important, as is "creating a positive security culture" where individuals can react and respond quickly to threats.

## 8. What Responsibilities do Firms Have?

The PRA's latest communication reveals that firms still have some way to addressing cyber underwriting risk and, in particular, their potential exposure to non-affirmative cyber risk. The FCA is separately concerned that insurers, among other financial services firms, practice good cybersecurity.

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 cybersecurity measures that will protect their data and their business.

## VI. Select Tax Issues Affecting Insurance Companies and Products

### A. U.S. TAX ISSUES

#### 1. Overview

As reported in last year's edition of the *Sidley Global Insurance Review*, the TCJA represented the most significant effort at tax reform since the 1986 Act and contained a number of provisions specific to the insurance industry. Most of the developments this year took the form of regulations or other guidance for the application and interpretation of the TCJA. The most significant of these are discussed below.

#### 2. Base Erosion Anti-Abuse Tax

The TCJA imposed a new corporate "base erosion" minimum tax at a 10% tax rate (5% for 2018) on "modified taxable income" ("**MTI**") (colloquially, the BEAT). 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 was made to the federal excise tax on outbound insurance and reinsurance premiums.

In last year's edition of the *Sidley Global Insurance Review*, we reported a number of uncertainties as to the application of the BEAT to insurance. In particular, in relevant part, we noted:

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; whether the addback to taxable income should 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; and
5. Determination of the base erosion minimum tax on a consolidated basis for affiliated groups.

On December 13, 2018, the Treasury Department and the IRS issued proposed regulations (the "**Proposed Regulations**") on the application of the BEAT and addressed some of these items:

1. As was widely expected, the Proposed Regulations do not treat amounts paid to a foreign related party that are subject to U.S. income taxation as effectively connected income (ECI) of a U.S. branch, or income attributable to a permanent establishment under an applicable U.S. tax treaty, as base erosion payments subject to add-back. That result is quite sensible, as payments by a U.S. person to an affiliate subject to U.S. income tax do not erode the U.S. tax base.
2. The Proposed Regulations acknowledge the uncertainty regarding the treatment of offsetting or related payments to foreign affiliates. The Proposed Regulations state that taxpayers generally may not net payments for BEAT purposes to any greater degree than allowed under general tax principles, but specifically request comments on whether a special rule should apply to reinsurance contracts.
3. The Proposed Regulations acknowledge that loss and claim reimbursements paid or incurred to related foreign companies that purchase coverage from a U.S. affiliate would appear to fall within the scope of the BEAT addback and ask for comments as to whether that is appropriate. The Proposed Regulations also appear to acknowledge the apparent difference in the treatment of such payments depending on whether they are made by life insurance companies (treated as deductions, generally subject to BEAT) or non-life insurance companies (generally treated as a reduction of underwriting income and not explicitly treated as base erosion payments under the statute). The Proposed Regulations request comment on whether that distinction is appropriate.
4. Although the Proposed Regulations do not provide explicit guidance on the treatment of modified coinsurance, the discussion regarding reinsurance agreements that call for netting of offsetting payments would presumably be relevant here as well.
5. The Proposed Regulations confirm that BEAT will be imposed and calculated on a consolidated basis for affiliated groups.

The Proposed Regulations provide that taxpayers are entitled to rely on them so long as they are consistently applied by the taxpayer and all related parties of the taxpayer.

#### 3. Guidance on Life Insurance Reserves

On December 13, 2018, the IRS released Revenue Procedure 2019-10 (the "**Revenue Procedure**"), addressing the amendment of section 807(f)<sup>16</sup> under the TCJA. Before amendment, that provision

<sup>16</sup> In this Part VI, references to "section" are to sections of the Internal Revenue Code, unless otherwise indicated.

spread certain required adjustments from a life insurer's change in the basis for determining a reserve item over a period of 10 years beginning with the year after the year of change. As amended, section 807(f) provides that such required adjustments from a change in reserve basis made after 2017 are "section 481 adjustments" treated as adjustments pursuant to a change in method of accounting initiated by the taxpayer and made with consent of the IRS.

Then Revenue Procedure provides that companies with remaining 10-year spread adjustments from pre-2018 changes continue to take those items into account for 2018 and later years to the extent of the remaining 10-year spread period. The Revenue Procedure also clarifies the starting point for computing the TCJA "transition adjustment" amount for a taxpayer that had a change in reserve basis for 2017, and confirms that the calculation of the increase or decrease in tax reserves for a "year of change" in 2018 or later will be consistent with the same calculation under prior-law section 807(f). However, under the amended version of section 807(f), the adjustment period is the year of change plus three years if reserves are decreased due to the change, and the year of change itself if reserves are increased due to the change (under prior law, the adjustment period was 10 years starting with the year after the year of change in all cases).

The Revenue Procedure also grants automatic IRS consent for changes in reserve basis, on essentially the same terms under which automatic consent is granted for many other accounting method changes (see Rev. Proc. 2015-31). Insurers changing reserve basis will now be required to file an IRS Form 3115 consistent with those other automatic consent procedures and may be entitled to so-called "audit protection" for years prior to the year of change, again, consistent with other IRS procedures. The Revenue Procedure clarifies, however, that automatic IRS consent to a change in reserve basis is not a determination that the new basis is permissible, and the new basis can still be challenged on audit for the year of change or later years.

#### 4. Joint Committee on Taxation TCJA "Blue Book"

On December 20, 2018, the Joint Committee on Taxation ("JCT") issued a general explanation of the TCJA (also referred to as a "Blue Book"). The explanation devotes a section to various provisions of the TCJA related to the insurance industry, including the following:

- Net Operating Losses of Life Insurance Companies (relating to section 805);
- Repeal of Small Life Insurance Company Deduction (relating to former section 806);
- Adjustment for Change in Computing Reserves (relating to section 807(f));
- Repeal of Special Rule for Distributions to Shareholders from Pre-1984 Policyholders Surplus Account (relating to former section 815);
- Modification of Proration Rules for Property and Casualty Insurance Companies (relating to section 832(b));

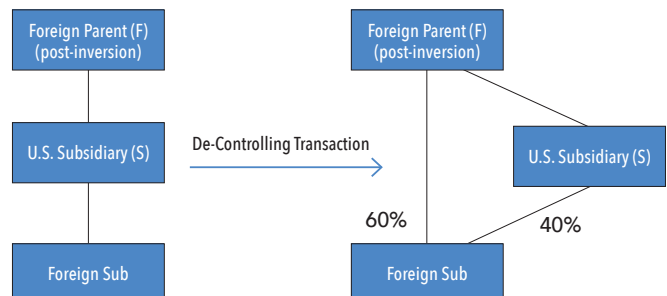
- Repeal of Special Estimated Tax Payments (relating to former section 847);
- Computation of Life Insurance Tax Reserves (relating to section 807);
- Modification of Rules for Life Insurance Proration for Purposes of Determining the Dividends Received Deduction (relating to section 812);
- Capitalization of Certain Policy Acquisition Expenses (relating to section 848);
- Tax Reporting for Life Settlement Transactions and Clarification of Tax Basis of Life Insurance Transactions, and Exception to Transfer for Valuable Consideration Rules (relating to sections 101, 1016(a) and 6050Y);
- Modification of Discounting Rules for Property and Casualty Insurance Companies (relating to section 846(c)).

#### 5. Technical Corrections Discussion Draft

On January 2, 2019, ranking member (and former Chair) of the House Ways and Means Committee Kevin Brady (R-TX) released a draft (the "**Discussion Draft**") of a bill for technical corrections to the TCJA. Titled the "Tax Technical and Clerical Corrections Act," the Discussion Draft has not been formally introduced in the House and will likely be subject to extensive negotiations. But commenters have suggested that it shows what Republicans think a technical corrections bill should include. The JCT also released a "Technical Explanation" of the Discussion Draft. A full analysis of the proposed corrections is beyond the scope of this review, but some of the most relevant and significant corrections are noted below:

##### a. CFCs—Downward Attribution

The TCJA repealed section 958(b)(4), which had the effect of permitting so-called "downward attribution" of stock ownership from a foreign person to a U.S. entity in which the foreign person owns an equity interest. This significantly expanded the circumstances in which a foreign corporation is a CFC. A blanket repeal appeared contrary to what Congress likely intended, which was a more narrow application of downward attribution. The provision appears to be more narrowly targeted at "decontrolling transactions" in connection with inversions, in which a portion of the stock of a foreign subsidiary of a U.S. target is distributed up the corporate chain to prevent CFC status of the foreign subsidiary (see below).



Under prior law, Foreign Sub would not be a CFC because only 40% of its stock was owned by a U.S. Person, S. Following the repeal of section 958(b)(4), S is treated as owning the stock of Foreign Sub owned by its parent (i.e., the remaining 60%), which preserves Foreign Sub's status as a CFC.

The proposed provision in the technical corrections bill restores the language of section 958(b)(4) as a general rule but provides an exception for limited downward attribution that is consistent with the narrower intent of the TCJA. Under the provision, a U.S. person that would directly or indirectly own more than 50% of a foreign corporation if downward attribution were applied is taxable on the subpart F income of the foreign corporation as if such corporation were a controlled foreign corporation, and the foreign corporation is treated as a controlled foreign corporation of which the U.S. person is a U.S. shareholder for purposes of applying sections 951A (GILTI) and 965 (transition tax inclusion) to the U.S. person.

#### **b. DAC Tax Capitalization Rates**

The TCJA increased the DAC capitalization rates to 2.09% for annuity business, 2.45% for group life, and 9.2% for other specified contracts (e.g., individual life business)—or at least it intended to. But because of erroneous statutory references in the text of the TCJA, it did not actually achieve the desired changes to the text of section 848. The Discussion Draft would fix the statutory language directly, clarifying the new percentages.

#### **c. P&C Loss Reserve Discounting**

The TCJA extends, in certain cases, the 10-year assumed loss payment period for discounting unpaid losses of P&C companies. The Discussion Draft would “clarify” (according to the Technical Explanation) that the 10-year period, with any extensions, applies to reinsurance and international lines of business.

#### **d. CFCs—10% Shareholder by Value**

The TCJA expanded 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. Prior law limited such status to U.S. persons owning 10% or more of the *voting power*. The Discussion Draft would modify section 1248—generally, treating gains from the sale or exchange by U.S. shareholders of stock in CFCs as dividend income—to reflect this change. Currently, the text of section 1248 applies only to sales of foreign companies meeting the old 10% voting power standard.

#### **e. Corrections to Other Insurance Provisions**

The Discussion Draft would fix incorrect or obsolete references in other provisions of post-TCJA law relating to insurance taxation. For example, it would correct a reference in section 817A(e)(2) (relating to computation of life insurance tax reserves for modified guaranteed contracts), which incorrectly refers to an interest rate in prior law that was moved as part of TCJA. Also, it would correct obsolete references to the prior-law term “loss from operations” in section 805 (relating to general deductions) and substitute “net operating loss.”

### **6. P&C Loss Reserve Discounting**

On December 19, 2018, the IRS released Revenue Procedure 2019-6, implementing provisions of the TCJA addressing loss reserve discounting. The TCJA generally required steeper discounting by (i) extending assumed loss payment patterns over a longer period of years and (ii) using discount rates based on a corporate bond yield curve instead of the “applicable federal rate” used under prior law. The essential purpose of the change was to accelerate taxable income of insurers into a budget-forecast period to partially offset the cut in the corporate income tax rate during that period.

Revenue Procedure 2019-6 sets forth the new discount factors to be used for unpaid losses incurred during 2018 and prior years. Those factors are to be used in discounting December 31, 2017 unpaid losses for all pre-2018 accident years for determination of the “transition adjustment” amount that is included in income of P&C insurers over the period 2018 to 2025. The same factors are to be used for discounting accident year 2018 unpaid losses.

The above guidance followed on the heels of proposed regulations published November 7, 2018, where the IRS proposed to determine discount rates by reference to yields on certain corporate bonds having maturities stretching out as far as 17.5 years. Critics of these proposed regulations pointed out that they were inconsistent with the apparent legislative intent to derive discount rates that generally match the yields on the bond investments that P&C insurers hold to fund their future loss payments. Critics also observed that such insurers are generally not attempting to match the durations of their assets and liabilities (unlike life insurers) and that the average maturity of a P&C insurer's bond portfolio is only around six or seven years.

Further IRS guidance remains pending. Revenue Procedure 2019-6 indicates that if the proposed regulations are modified when made final—for example, to use corporate bond yields for shorter maturities—the IRS will publish revised discount factors and will follow procedures that give the revised factors full effect (including for purposes of the “transition adjustment” amount).

### **7. Special Treatment for Loss Carrybacks for P&C Companies**

As noted in last year's edition of the *Sidley Global Insurance Review*, for losses arising in tax years beginning after 2017, the TCJA repealed carryback provisions for life insurance companies, as it did for non-insurance companies, and made 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, however, retained the pre-existing “2-and-20” carryback and carryover periods without the 80% limitation described above.

Commentators noted that the application of this rule to consolidated groups consisting of P&C insurance companies and non-insurance companies could be quite complicated: for example, it is not clear it would be appropriate for NOLs arising out of P&C insurance operations to be allowed to be carried back and offset non-insurance income. This question would become even more complicated in the context of life/non-life consolidated groups, which already contain complicated sub-group rules that require life insurance companies

to compute income and losses separately from all other corporations in the affiliated group. Carried to its extreme, this concept could be interpreted by Treasury Regulations to require that tax of such a consolidated group be calculated with respect to *three* sub-groups: life insurance income, insurance income other than from life insurance, and non-insurance income. Such a regime would complicate an already complicated area of the law.

## 8. Treatment of Insurance Companies Under the PFIC Provisions

Section 1297 defines Passive Foreign Investment Companies (“**PFICs**”) as foreign corporations if 75% or more of their gross income consists of passive income or 50% or more of their assets consist of assets producing, or held for the production of, passive income. As part of the pre-TCJA PFIC regime, passive income for purposes of section 1297 excluded income derived from the active conduct of an insurance business by a company predominantly engaged in the business of insurance that would be subject to tax under Subchapter L if it were a domestic corporation (and to the extent the company’s reserves did not exceed the reasonable needs of its business).

The TCJA maintains a special rule for certain insurance companies. Specifically, under section 1297(b)(2)(B), passive income does not include income derived from the active conduct of an insurance business by a “qualifying insurance company,” defined as a foreign corporation which would be subject to tax under Subchapter L if it were a domestic corporation and whose insurance liabilities constitute more than 25% of its total assets.

The PFIC regime also provides for a look-through rule (under section 1297(c)) which requires that a foreign corporation that owns at least 25% of another corporation (whether directly or indirectly) include a proportionate share of the income and assets of such corporation when determining the parent’s PFIC status.

The interaction of the look-through rule under section 1297(c) and the definition of “qualifying insurance company” suggests the odd result that in determining whether a foreign company is a PFIC, an investment by such foreign company in a *domestic* insurance subsidiary is treated as passive. This result follows because the carve-out from passive income for active insurance income is restricted to “qualifying insurance companies,” and that term includes only certain *foreign* corporations. As a result it would appear the investment in a domestic taxpaying entity will tend to *increase* the likelihood that a foreign corporation is treated as a PFIC, a counterintuitive result.

Neither the TCJA Blue Book nor the Discussion Draft of the technical corrections bill addresses this issue. We understand based on informal discussions that the Treasury Department agrees this represents an error in the statute, but we are not aware that any formal efforts to correct the error have been taken.

## B. INTERNATIONAL TAX ISSUES: THE OECD BEPS PROJECT

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, *Addressing Base Erosion and Profit Shifting*, and an “action plan” identifying 15 action 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.<sup>17</sup> It describes the recommendations as “soft law,” i.e., they are not self-enforcing, and 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 here.

### 1. Country-by-Country Reporting

Arguably the recommendation most widely adopted to date has been county-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 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 U.S., the UK 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, 76 countries have joined, including Bermuda, Canada, Germany, Guernsey, Ireland, the Isle of Man, Jersey, Luxembourg, Mauritius, Switzerland and the UK.

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. Modification of Tax Treaties: 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

<sup>17</sup> For a lengthier discussion of those recommendations, see the 2016 *Sidley Global Insurance Review*, available at <https://www.sidley.com/-/media/update-pdfs/2016/04/2016sidleyglobalinsurancereview.pdf>.

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. The text of the convention was agreed in November, and an initial signing ceremony is scheduled for June 2017.

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 when a person should be considered a "qualifying person" seek to ensure 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, 87 countries have signed the multilateral instrument including Canada, Germany, Guernsey, Ireland, Isle of Man, Jersey, Luxembourg, Switzerland and the UK. In terms of timing, the MLI will apply as between two jurisdictions on the date falling three months after the second jurisdiction has deposited its instrument of ratification and its final list of reservations and notifications with the OECD. Changes to the tax treaty in place between such jurisdictions will generally take effect six months thereafter (except in relation to withholding taxes where the changes take effect on the first day of the following calendar year). 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 options set forth above in section VI.B.2.

## C. UK/EU TAX DEVELOPMENTS

### 1. UK's ILS Initiative

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

### 2. Brexit and Tax

Due to ongoing Brexit negotiations, the tax related consequences of Brexit (whatever form it may take) are not entirely clear. It is expected however, that UK companies will lose the benefit of the Parent-Subsidiary Directive and Interest and Royalties Directive. Accordingly, a UK company receiving or paying interest, dividends or royalties from EU-based related parties may need to rely on the

provisions of any applicable double tax treaty to reduce the rate of any withholding tax on such payments. In some instances, the applicable tax treaty may not reduce any such withholding tax rate to zero. Companies should also monitor the effect of Brexit on their VAT positions. Imports of goods from (and exports of goods to) the EU will become imports (or exports) from a third country, which may attract import VAT. For insurance companies that recover input VAT on the basis of insurance related supplies made to businesses situated outside the EU there is not yet clarity on whether such special VAT recovery treatment may extend to all insurance related services made to persons outside the UK (for example, persons situated in the EU) following Brexit. Separately, EU nationals working in the UK may not have the same social security rights as currently afforded under EU law and pre-EU social security treaties may need to be revisited. In any event, the UK will lose its ability to have input into EU tax policy which could affect entities outside the EU (e.g., the proposed financial transactions tax).

### 3. EU Blacklist and New Bermuda Substance Laws

On December 5, 2017, the EU published its list of 17 non-cooperative tax jurisdictions (the "**EU Blacklist**") directed at counteracting the effects of preferential tax regimes around the world. During the course of 2018, the list was reduced such that it now includes only American Samoa, Guam, Samoa, Trinidad and Tobago and the U.S. Virgin Islands. Importantly, 47 jurisdictions were originally placed on the so-called "greylist," representing those counties that avoided 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 OECD BEPS minimum standards.

Of note to the insurance industry, Bermuda committed to improve substance requirements and introduced legislation effective as of January 1, 2019 which requires entities carrying on "relevant activities" (which includes insurance business and other financial activities) to demonstrate that they meet certain "substance requirements," with relevant factors including (i) being managed and directed in Bermuda, (ii) core income generating activities being undertaken in Bermuda and (iii) an adequate physical presence, number of employees and operating expenses incurred in Bermuda. Jersey, Guernsey, the Isle of Man and the Cayman Islands, have introduced similar legislation. The EU is set to meet in the first quarter of 2019 to discuss whether such legislation is adequate (or alternatively whether a jurisdiction should be placed on the EU Blacklist). The sanctions that apply as a result of being included on the EU Blacklist are primarily determined by individual member states, but EU recommended sanctions include increased audits on entities with a link to blacklisted jurisdictions as well as the imposition of withholding taxes on payments made to entities based in such countries.

### 4. The EU Anti-Tax Avoidance Directives

On January 28, 2016 the EU presented its proposal for an Anti-Tax Avoidance Directive ("**ATAD**"). On May 29, 2017, the EU amended ATAD with Directive (EU) 2017/952 ("**ATAD 2**"). ATAD and ATAD 2 contain various measures that could have an effect on insurance companies. Of particular note to insurance companies are (a) the "interest limitation rules" which, broadly, restrict the tax deductible

interest of an entity to 30% of EBITDA, subject to an allowable de minimis of £2 million of net interest expense, and (b) the “hybrid mismatch rules” which, broadly, are designed to counteract arrangements where a payment or quasi-payment gives rise to a double tax deduction or tax deduction for one party without a corresponding inclusion of income for the other party. Other measures prescribed by ATAD and ATAD 2 include exit taxes (e.g., on transfers of permanent establishments or tax residence), rules that attribute the income of a controlled foreign company to its (direct or indirect) controlling company, and a general anti-avoidance rule. EU member states were (subject to derogations for certain states) under an obligation to implement ATAD in their domestic law by January 1, 2019 and have until December 31, 2019 to implement ATAD 2 (except for certain measures relating to reverse hybrid mismatches, which must be implemented by December 31, 2021).

### 5. The UK’s Profit Diversion Compliance Facility

The UK tax authority (“**HMRC**”) recently introduced a new profit diversion compliance facility. HMRC considers that some MNEs have adopted cross border pricing arrangements which are either based on an incorrect fact pattern and/or are not consistent with the OECD Transfer Pricing Guidelines as clarified through Action Points 8-10 of the OECD BEPS Project. The new facility is intended to provide in-scope MNEs (i.e., MNEs using arrangements that are targeted by the UK’s diverted profits tax) with an opportunity to bring their UK tax affairs up to date. According to HMRC, such arrangements typically reduce UK profits by under-rewarding UK activity and over-rewarding activity based in an overseas entity where its profits are taxed at lower rates or not taxed at all. If an MNE is confident that its transfer pricing is up to date and it is paying the right amount of UK corporation tax, then HMRC states that the MNE should not use the facility. HMRC may contact businesses if its ongoing risk analysis indicates that such business has a combination of features commonly associated with profit diversion. Insurance groups potentially within the scope of the UK’s diverted profits tax should consider the use of the facility in order to control the way in which any HMRC investigation is initially carried out. To the extent that the transfer pricing position of the MNE concerned has to be amended as a result of any investigation, it will have to pay additional taxes and interest plus possibly penalties (which will be treated as mitigated by the use of the facility).

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