



March 2020

# SIDLEY GLOBAL INSURANCE REVIEW

---

## SIDLEY



# SIDLEY GLOBAL INSURANCE REVIEW

March 2020

The insurance industry is global in nature. Insurers and reinsurers are critically important to the world economy, assuming and transferring risk across each continent and serving as an enormous investor base for the world's capital markets. Risk generated in one part of the world is distributed immediately across multiple markets to traditional and new market entrants alike — insurers, reinsurers, private equity sponsors, capital market investors and others. Regulatory issues arising in one market may influence the way in which similar regulatory concerns are addressed in other markets; the insurance industry constantly evolves and requires regulatory regimes and market participants to adapt on a frequent basis.

For a full understanding of the insurance industry, it is essential to have a grasp of the global trends and developments that bear upon that industry. We prepared the *Sidley Global Insurance Review* as a tool to assist readers in obtaining such an understanding. This publication provides an overview of major legal and market developments in the global insurance industry over the past year, with a focus on the United States, United Kingdom, European Union, Asia and other markets with significant insurance industry activity, such as Bermuda.

This review was prepared on the cusp of the novel coronavirus (COVID-19) pandemic, which of course is continuing to affect the global insurance industry in a multitude of unique ways. All stakeholders in the insurance industry, be they carriers, producers, or consumers, are affected by this global public health crisis and its economic consequences in ways that are hard to predict. Given the rapidly evolving issues associated with the pandemic, we think it premature to make any meaningful assessment or forecast of the impact of COVID-19 on the insurance industry. That said, the insights and analysis presented in this review should be viewed through the prism of the challenges and uncertainties posed by COVID-19, which by all measures appear significant.

Sidley Austin LLP has organized a multidisciplinary task force to address the wide range of regulatory, transactional and litigation issues companies face in responding to the COVID-19 outbreak. We have established a COVID-19 Resource Center covering a variety of pertinent topics, available at <https://www.sidley.com/en/insights/resources/coronavirus-resources>, and will continue to share periodic briefings with our clients and friends. To assist stakeholders in the insurance industry, we have assembled a compendium of materials issued by the NAIC and U.S. state insurance departments in response to COVID-19, available at <https://www.sidley.com/covid19-insurance-compendium>, and will continue to periodically update this compendium.

This review has been produced by Sidley's Insurance and Financial Services group. 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 find the 2020 edition of the *Sidley Global Insurance Review* to be a valuable tool in navigating the insurance market.

---

*Attorney Advertising - Sidley Austin LLP, One South Dearborn, Chicago, IL 60603. +1 312 853 7000. Sidley and Sidley Austin refer to Sidley Austin LLP and affiliated partnerships as explained at [www.sidley.com/disclaimer](http://www.sidley.com/disclaimer). Prior results do not guarantee a similar outcome. Some photos on this brochure may be of actors and not of clients or firm personnel.*

*This Global Insurance Review has been prepared by Sidley Austin LLP for informational purposes only and does not constitute legal advice. This information is not intended to create, and receipt of it does not constitute, an attorney-client relationship. Readers should not act upon this without seeking professional counsel.*

*© 2020 Sidley Austin LLP and Affiliated Partnerships (the "firm"). All rights reserved. The firm claims a copyright in all proprietary and copyrightable text in this report.*

# 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. Trends in Insurance M&A Activity .....	3
a. Strategic Focus .....	3
b. Expansion and Diversification .....	3
c. Private Equity .....	4
d. Insurtech .....	5
3. The Growth of Representations and Warranties Insurance in Insurance M&A .....	5
4. Outlook .....	5
<b>B. European Markets.....</b>	<b>7</b>
1. Introduction .....	7
2. Lloyd's .....	7
3. Broker M&A and Private Equity .....	7
4. Insurtech .....	8
5. Runoff and Restructuring Market .....	8
6. Other Insurance Company Transactions .....	9
<b>II. The Global Alternative Risk Transfer and Capital Markets.....</b>	<b>11</b>
<b>A. Life and Annuity Market .....</b>	<b>11</b>
1. The State of the Reserve Financing Market .....	11
a. Principles-Based Reserving Now Operative .....	11
b. Current State of SSAP 41R Clarifying Revisions .....	11
c. Adoption of Reserve Financing Model Regulation .....	11
2. Regulation XXX/Regulation AXXX Transactions .....	12
<b>B. P&amp;C Market.....</b>	<b>13</b>
1. Catastrophe Bonds .....	13
2. Market Response to Recent Catastrophe Losses .....	14
3. Sidecars .....	14
4. Global ILS Initiatives .....	14
5. M&A Activity .....	15
6. Outlook Ahead .....	15
<b>C. Prudential Regulation Authority Consults on Updates to the UK's ILS Regime .....</b>	<b>16</b>
1. Proposals Regarding Funding Arrangements .....	16
2. Proposals Regarding "Documentation Requirements" .....	17
3. Proposals Regarding Risk Transfer Requirements .....	17
4. UK ILS Outlook .....	17
<b>D. Traditional Capital Markets .....</b>	<b>18</b>
<b>III. The Global Longevity Market.....</b>	<b>21</b>
<b>A. Transaction Structures .....</b>	<b>21</b>
1. Buyouts .....	21
2. Buy-Ins .....	21
3. Longevity Swaps .....	21

4. Index-Based Trades .....	22
<b>B. U.S. Market .....</b>	<b>22</b>
<b>C. UK/European Markets .....</b>	<b>23</b>
<b>IV. Global Regulatory and Litigation Developments .....</b>	<b>25</b>
<b>A. U.S. NAIC and State Activity .....</b>	<b>25</b>
1. NAIC Amendments to Credit for Reinsurance Model Law and Regulation to Implement U.S.-EU and U.S.-UK Covered Agreements .....	25
2. Life Insurance and Annuities .....	26
a. NAIC Adopts Amendments to Suitability in Annuity Transactions Model Regulation .....	26
b. New York Best Interest Standard .....	26
c. NAIC Evaluates Age Restrictions on Indices Used in Annuity Illustrations .....	27
d. New York Issues Circular Letter Regarding Pension Risk Transfer Business and Soliciting, Negotiating, Selling and Servicing Group Annuity Contracts Issued by Unauthorized Insurers .....	27
3. Health Insurance Regulation — ACA Risk Corridor and Cost-Sharing Reduction Litigation .....	28
4. NAIC Activity Relating to International Insurance Activities .....	29
a. Update on IAIS Activities .....	29
i. ComFrame and the ICS .....	29
ii. The Holistic Framework .....	29
b. NAIC Development of Group Capital Calculation .....	30
5. NAIC Updates Regarding Valuation of Securities .....	30
a. Principal-Protected Notes and “Bespoke” Securities .....	30
b. Expansion of Fixed-Income Treatment to Certain Qualifying Funds .....	31
6. NAIC Considers Revisions to Statements of Statutory Accounting Principles .....	31
a. Identification of Related Parties and Affiliates .....	31
b. Levelized and Persistency Commission Arrangements .....	32
c. Treatment of Collateralized Fund Obligations .....	32
d. Surplus Notes .....	33
7. States Continue Efforts to Address Innovation and Technology in the Insurance Sector .....	34
a. State Adoption of Insurance Data Security Model Law .....	34
b. NAIC Activity Related to Anti-Rebating Laws .....	34
c. NAIC Continues to Consider the Use of Big Data and Blockchain Technology in the Insurance Industry .....	35
d. Best Practices for Regulatory Review of Predictive Analytics White Paper .....	35
e. Accelerated Underwriting Working Group .....	35
f. New York Department of Financial Services Issues Guidance Regarding Life Insurers’ Use of External Consumer Data in Underwriting .....	36
g. AI Working Group .....	37
8. Privacy .....	37
a. California Consumer Privacy Act .....	37
b. NAIC Privacy Protections Working Group .....	38
9. NAIC Activity Related to Long-Term Care Insurance .....	38
10. NAIC Adopts White Paper on Understanding the Market for the Legalized Cannabis Business .....	38
11. NAIC Prepares Best Practices Guidance Related to Final Federal Flood Insurance Rule .....	39
12. NAIC Discusses Mechanisms for Voluntary Restructuring of Solvent Insurers .....	39
13. NAIC and State Insurance Departments Respond to COVID-19 Pandemic .....	40
a. Regulatory Guidance Related to Health Insurance Operations and Coverage .....	40

b. Regulatory Guidance Related to Travel Insurance Coverage . . . . .	41
c. Regulatory Guidance Related to Business Interruption Insurance Coverage . . . . .	41
d. Regulatory Guidance Related to Operational Issues for Regulators, Insurers and Other Regulated Entities . . . . .	41
<b>B. U.S. Federal Activity . . . . .</b>	<b>41</b>
1. FSOC — Changes to Non-Bank SIFI Designation Guidance . . . . .	41
2. SEC Best Interest Regulation . . . . .	42
3. Derivative Transactions . . . . .	43
a. Initial Margin Requirement Phase-In Extended . . . . .	43
b. IM Rules Application . . . . .	44
c. IM Rules Requirements . . . . .	44
4. U.S. Response to Cessation of LIBOR and Transition Risk . . . . .	44
<b>C. International (Non-U.S.) Insurance Issues . . . . .</b>	<b>46</b>
1. Brexit's Impact on the European Insurance Market . . . . .	46
a. Introduction . . . . .	46
b. The Brexit Withdrawal Bill . . . . .	46
c. Option (i): A Trade Deal With the EU is Achieved . . . . .	47
d. Option (ii): "No-Deal" Brexit . . . . .	47
e. How are (Re)insurers Preparing for Brexit? . . . . .	49
2. Lloyd's Update . . . . .	49
a. Complex Risk Platform . . . . .	49
b. Lloyd's Risk Exchange . . . . .	49
c. Claims Modernization . . . . .	49
d. Lloyd's Capital Solution(s) and Other Related Developments . . . . .	50
e. Syndicate in a Box . . . . .	50
f. Services Hub . . . . .	50
g. Other Relevant Developments . . . . .	51
3. SM&CR to Be Extended to FCA Solo-Regulated Firms . . . . .	51
a. Scope of the SM&CR . . . . .	51
b. SMFs . . . . .	52
c. Prescribed Responsibilities . . . . .	52
d. Duty of Responsibility . . . . .	52
e. Certification Regime . . . . .	53
f. Conduct Rules . . . . .	53
g. Next Steps . . . . .	54
4. PRA Consultation Paper on the Solvency II Prudent Person Principle . . . . .	54
5. Cyber Risk . . . . .	55
a. Cyber Insurance Market . . . . .	56
b. PRA, FCA and EIOPA Initiatives and Communications . . . . .	57
i. PRA . . . . .	57
ii. FCA . . . . .	57
iii. EIOPA . . . . .	57
6. Other UK Regulatory Developments . . . . .	58
7. EU and Member State Competition Law Enforcement Activity . . . . .	60
a. EU-Level Enforcement by the European Commission and by the EU Courts . . . . .	60

i. European Commission . . . . .	60
ii. EU Courts . . . . .	61
b. National Level Enforcement in the UK . . . . .	61
i. FCA Publishes Final Report on Wholesale Insurance Brokers Market Study . . . . .	61
ii. FCA Publishes Report on the General Insurance Distribution Chain . . . . .	61
iii. FCA Continues Its Probe Into Discrimination in Insurer Pricing Algorithms . . . . .	61
c. National Level Enforcement in Belgium . . . . .	61
d. National Level Enforcement in Bulgaria . . . . .	61
e. National Level Enforcement in Denmark . . . . .	62
f. National Level Enforcement in Finland . . . . .	62
g. National Level Enforcement in France . . . . .	62
h. National Level Enforcement in Germany . . . . .	62
i. National Level Enforcement in Ireland . . . . .	62
j. National Level Enforcement in Latvia . . . . .	62
k. National Level Enforcement in Netherlands . . . . .	62
l. National Level Enforcement in Portugal . . . . .	63
m. National Level Enforcement in Romania . . . . .	63
n. National Level Enforcement in Sweden . . . . .	63
8. Impact of EU and UK Data Privacy Developments on the Insurance and Reinsurance Industry . . . . .	63
a. GDPR Enforcement and Fines . . . . .	63
b. Profiling and Artificial Intelligence . . . . .	64
c. Accountability and the GDPR . . . . .	65
d. Brexit . . . . .	65
e. Transfers of Personal Data From the EEA/UK . . . . .	66
f. Business Marketing . . . . .	66
g. Controllers and Processors . . . . .	66
h. Privacy Rights and Privacy Litigation . . . . .	67
i. Final Thoughts . . . . .	68
<b>V. Select Tax Issues Affecting Insurance Companies and Products . . . . .</b>	<b>69</b>
<b>A. U.S. Tax Issues . . . . .</b>	<b>69</b>
1. Impacts of COVID-19 . . . . .	69
2. Tax Reform . . . . .	69
3. Base Erosion and Anti-Abuse Tax . . . . .	69
4. Treatment of Insurance Companies Under the PFIC Proposed Regulations . . . . .	70
5. P&C Loss Reserve Discounting . . . . .	72
6. Guidance on Reserves of Life Insurance Companies . . . . .	72
<b>B. International Tax Issues: The OECD BEPS Project . . . . .</b>	<b>72</b>
1. Modification of Tax Treaties: Multilateral Instrument . . . . .	73
<b>C. UK/EU Tax Developments . . . . .</b>	<b>73</b>
1. Brexit and Tax . . . . .	73
2. EU Blacklist and New Substance Laws . . . . .	74
3. The EU Anti-Tax Avoidance Directives . . . . .	74





## I. The Global Mergers and Acquisitions Market

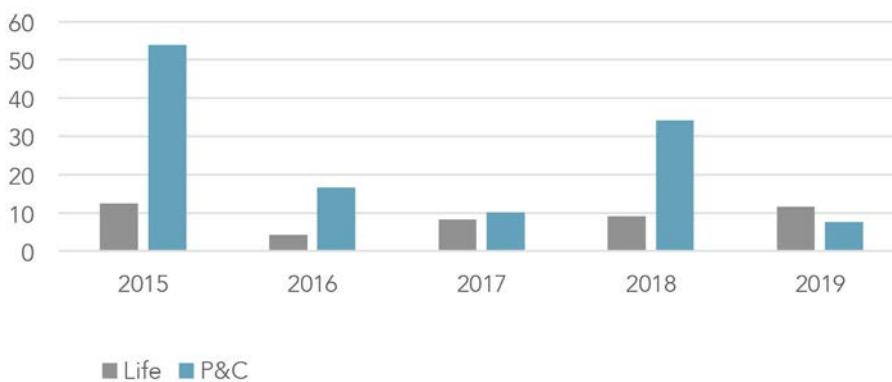
### A. NORTH AMERICAN MARKET

#### 1. Introduction

Following an active deal market in 2018, the pace of insurance industry mergers and acquisitions (“**M&A**”) activity remained brisk in 2019. In all, during the 2019 calendar year, 534 deals were announced involving U.S.- or Bermuda-based buyers or targets (compared to 533 in 2018). While deal volume was comparable, aggregate reported deal value fell 51% in 2019 relative to 2018 (from US\$40.3 billion in 2018 to US\$19.9 billion in 2019).<sup>1</sup> The decline was attributable in large part to a relative dearth of multi-billion dollar transactions on par with those announced in 2018, such as AXA Group’s (“**AXA**”) acquisition of XL Group Ltd. for US\$15.4 billion or American International Group Inc.’s (“**AIG**”) US\$5.6 billion purchase of Validus Holdings Ltd.

*While aggregate insurance M&A deal value declined in 2019, the last three months of 2019 were notably robust, with US\$13.08 billion in transactions announced during the fourth quarter.*

North American Insurance Underwriter M&A Value (US\$ billions)



Source: Growing array of buyers projected to promote stability in insurance carrier M&A, S&P Global Market Intelligence.

While aggregate insurance M&A deal value declined in 2019, the last three months of 2019 were notably robust, with US\$13.08 billion in transactions announced during the fourth quarter. This marked the highest fourth-quarter total in three years and the second-highest fourth-quarter total in the past 13 years.<sup>2</sup> Such activity was driven in large part by M&A in the life insurance sector, which reached a four-year high of US\$11.7 billion in 2019. Insurance M&A is off to a brisk start in 2020, with two multi-billion dollar deals announced just prior to the publication of this year’s *Sidley Global Insurance Review*: the US\$9.0 billion acquisition of PartnerRe Ltd. (“**PartnerRe**”) by SGAM Covéa (“**Covéa**”) (discussed below), and Aon PLC’s (“**Aon**”) agreement to purchase Willis Towers Watson PLC for US\$30.1 billion. Notwithstanding this early surge, it would be reasonable to anticipate that the outbreak of the novel coronavirus that emerged in late 2019 (COVID-19) and the concomitant shuttering of large swaths of the global economy and impact on global markets will inhibit insurance M&A activity, at least in the near term (although history tells us that distressed market conditions can have unpredictable consequences).

*...activity was driven in large part by M&A in the life insurance sector, which reached a four-year high of US\$11.7 billion in 2019.*

<sup>1</sup> *US Insurance Deals Insights: Q4 2019*, PwC.

<sup>2</sup> *Growing array of buyers projected to promote stability in insurance carrier M&A*, S&P Global Market Intelligence.



A table of notable insurance M&A transactions announced since the start of 2019 is provided below, ranked by deal value at the time of announcement.

Buyer	Target/Industry	Seller	Announcement Date	Approximate Value
Aon plc	Willis Towers Watson Public Limited Company	Individual shareholders	Mar. 9, 2020	US\$30.1 billion
SGAM Covéa	PartnerRe Ltd.	Exor NV	Mar. 3, 2020	US\$9.0 billion
New York Life Insurance Co.	Cigna's group business / Life & Health	Cigna Corp.	Dec. 18, 2019	US\$6.3 billion
Tokio Marine Holdings, Inc.	Privilege Underwriters, Inc. / P&C	Investor group	Oct. 3, 2019	US\$3.1 billion
Brookfield Business Partners L.P.	Genworth MI Canada, Inc. / Mortgage Guarantee Insurance	Genworth Financial, Inc.	Aug. 13, 2019	CAD\$2.4 billion
Fidelity National Financial, Inc.	FGL Holdings	Investor group	Feb. 7, 2020	US\$2.7 billion
Prudential Financial, Inc.	Assurance IQ, Inc. / Life & Health, Insurtech	Individual shareholders	Sept. 5, 2019	US\$2.4 billion
Carlyle, T&D Holdings, Investor Group	Fortitude Group Holdings / Reinsurance, Multiline	American International Group	Nov. 25, 2019	US\$1.8 billion
American Family Insurance Mutual Holding Company	IDS Property Casualty Insurance Co. (d/b/a Ameriprise Auto & Home Insurance)/&C	Ameriprise Financial, Inc.	Apr. 2, 2019	US\$1.1 billion
Resolution Life Group Holdings LP	Individual Life Business / Life & Health	Voya Financial, Inc.	Dec. 18, 2019	US\$1.1 billion
CopperPoint Insurance Companies	Alaska National Insurance Company / P&C	Individual shareholders	Sept. 17, 2019	US\$900 million
Catalina Holdings (Bermuda) Ltd.	Asia Capital Reinsurance Group Pte Ltd. / Reinsurance	Individual shareholders	Dec. 5, 2019	US\$667 million
ProAssurance Corporation	NORCAL Group	Individual policyholders	Feb. 20, 2020	US\$600 million
GoldenTree Asset Management LP	Syncora Guarantee Inc. / Financial Guarantee Insurance	Syncora Holdings Ltd.	Aug. 15, 2019	US\$429 million

## 2. Trends in Insurance M&A Activity

The primary catalysts driving insurance M&A activity in 2019 remained largely consistent with those observed in recent years. As we noted in last year's *Sidley Global Insurance Review*, in the midst of the current low interest rate environment, sellers have sharpened their strategic focus on core lines of business and looked for opportunities to exit supplementary, capital-intensive and/or less profitable legacy blocks of business. This continued in 2019. Sellers have found a market with counterparty buyers seeking to expand their product offerings, geographic reach and customer base. In addition, private equity investors and other financial buyers, with the access to cash and purchasing power that have made them major players in the insurance space, continued to target acquisitions and pursue strategic transactions for their portfolio companies. The interest of insurers in enhancing their data and analytic competencies, upgrading digital platforms and expanding distribution capabilities through the purchase of insurtech-focused companies continued unabated.

### a. Strategic Focus

Continuing a trend that has remained constant in recent years, sellers in 2019 looked for opportunities to divest non-core lines of business and to focus strategic efforts and redeploy capital in primary business lines. The sale by Cigna Corp. ("**Cigna**") of its group life and disability insurance business to New York Life Insurance Company ("**New York Life**") was 2019's most prominent example. Cigna's announcement of the US\$6.3 billion transaction, the largest insurance M&A deal announced in 2019, emphasized that the divestiture would allow Cigna to concentrate on distributing healthcare services to employers, health plans and government agencies (capabilities expanded through Cigna's 2018 acquisition of Express Scripts Holding Company), rather than group business that is less central to Cigna's current strategic vision and more capital-intensive relative to Cigna's core healthcare businesses.

Similar considerations seemed to underlie the sale by Voya Financial Inc. ("**Voya**") of its individual life and legacy non-retirement annuities business to Resolution Life Group Holdings LP ("**Resolution Life**"). The transaction accelerates approximately US\$1.7 billion in deployable capital from Voya's individual life business and, according to Voya's chairman and chief executive officer, will enable it to focus on the growth of its retirement, asset management and employee benefit businesses, which are high-growth, high-return and capital-light operations.

This trend was not limited to the life sector — Ameriprise Financial Inc.'s ("**Ameriprise**") sale of its auto and homeowners insurance business unit to American Family Insurance Mutual Holding Company ("**American Family Insurance**") was driven by Ameriprise's focus on its primary growth area of advice and wealth management. The transaction was announced in April 2019 and closed in October 2019.

### b. Expansion and Diversification

Sellers looking to divest non-core lines of business found a market of counterparties eager to expand their policyholder base or broaden their range of product offerings. Each of the Cigna, Voya and Ameriprise transactions involved buyers seeking to diversify their product portfolios or expand their geographic or demographic reach through the acquisition of sellers' non-core lines. For New York Life, the acquisition of Cigna's group disability and insurance business offered the opportunity to expand its employee benefits insurance operations and policyholder base, as well as diversify its product portfolio into a business that is less capital-intensive than New York Life's core individual life business. For Resolution Life, Voya's individual life business presented a third growth platform and an opportunity for continued growth in the U.S. The addition of Ameriprise's auto and homeowners insurance business allows American Family Insurance to rapidly scale up its presence in the California market.

A desire for geographic and demographic expansion drove a number of other insurance M&A deals in 2019. The acquisition by Tokio Marine Holdings ("**Tokio Marine**") of high-net-worth insurer Privilege Underwriters and its specialty insurance subsidiaries (PURE Group) for US\$3.1 billion advances Tokio Marine's expansion into the specialty lines business in developed countries. Tokio Marine has now consummated four deals with U.S. insurers since 2008, each valued at over US\$2.0 billion. CopperPoint Insurance Companies' ("**CopperPoint**") agreement to acquire Alaska National Insurance Company, an Alaska-domiciled workers' compensation and commercial insurance carrier, is another example of

*...in the midst of the current low interest rate environment, sellers have sharpened their strategic focus on core lines of business and looked for opportunities to exit supplementary, capital-intensive and/or less profitable legacy blocks of business.*

*...sellers in 2019 looked for opportunities to divest non-core lines of business and to focus strategic efforts and redeploy capital in primary business lines.*

*Sellers looking to divest non-core lines of business found a market of counterparties eager to expand their policyholder base or broaden their range of product offerings.*

buyers increasing their product offerings through M&A. The transaction, which closed in December 2019, bolstered CopperPoint's strategic plan to expand its portfolio of insurance products and its geographic reach beyond the southwestern region of the U.S.

These trends have remained in evidence into 2020, with Fidelity National Financial, Inc. ("**FNF**") agreeing in early February 2020 to acquire FGL Holdings ("**F&G**") for approximately US\$2.7 billion. The transaction marks the entry of FNF, a leading title insurer, into the life and annuity market, which it expects will diversify its cash and income streams and achieve countercyclical returns in economic environments challenging to its core title insurance business. F&G, which had been purchased in 2017 by a group of private equity investors, including Blackstone Group LP ("**Blackstone**"), is extending its investment management partnership with Blackstone, which will continue to provide asset management and investment support functions to the F&G investment portfolio following the closing of the transaction. On March 3, 2020, Exor NV entered into a memorandum of understanding with French insurer Covéa for the sale of PartnerRe, a Bermuda-based global reinsurer, to Covéa for cash consideration of US\$9.0 billion, plus a cash dividend of US\$50 million to be paid before closing. Covéa is a leading property and casualty ("**P&C**") insurer in France, and the acquisition of PartnerRe would mark Covéa's entry into reinsurance and asset management.

Where FNF sought to diversify its lines of business, ProAssurance Corporation ("**ProAssurance**") doubled down on underwriting medical liability insurance. On February 20, 2020, ProAssurance agreed to acquire NORCAL Group ("**NORCAL**") for US\$450 million (plus contingent consideration of up to US\$150 million if loss estimates as of the acquisition date develop favorably) following the demutualization of NORCAL Mutual Insurance Company ("**NORCAL Mutual**"), subject to required regulatory approvals and the assent of NORCAL Mutual policyholders. ProAssurance and NORCAL are both specialty insurers that provide coverage to healthcare professionals. In its press release, ProAssurance indicated that the acquisition would enhance its scale and capabilities, and provide access to the California physicians market at a time when the healthcare professional liability market is starting to harden. The combination of ProAssurance and NORCAL is expected to create the nation's third-largest specialty writer of liability insurance for healthcare professionals and facilities.

### c. Private Equity

The appetite of private equity and other financial buyers for insurance assets remained very much in evidence in 2019, driven in part by a desire to bring their asset management capabilities to the large pools of assets supporting insurance reserves. In November 2019, The Carlyle Group ("**Carlyle**") and Tokyo-based T&D Holdings, Inc. ("**T&D**") announced a US\$1.8 billion transaction with AIG pursuant to which Carlyle (through a newly created Carlyle-managed fund) would increase its ownership interest in Fortitude Group Holdings, LLC ("**Fortitude Holdings**"), a provider of retroactive reinsurance and legacy runoff management services, to 71.5% and T&D would acquire a 25% stake. This transaction followed Carlyle's 2018 acquisition of a 19.9% stake in Fortitude Holdings. In describing its rationale for the transaction, Carlyle specifically noted the prospect of further developing its global investment management services for Fortitude Holdings and the potential for delivering attractive returns across a variety of asset classes. The transaction is expected to close in mid-2020.

Private equity sponsors also sought to expand their portfolios in 2019. In August 2019, Brookfield Business Partners L.P. ("**Brookfield**") agreed to purchase a 57% controlling interest in Genworth MI Canada Inc., the largest private sector residential mortgage insurer in Canada. The transaction closed in December 2019. Brookfield's investment, valued at CAD\$2.4 billion, gives it a stake in the "high barrier to entry" mortgage insurance business.

In another notable acquisition by a financial buyer, Syncora Holdings Ltd. ("**Syncora**"), a Bermuda-domiciled holding company, announced in August 2019 its agreement to sell Syncora Guarantee Inc., a New York financial guarantee insurer, to an entity organized by GoldenTree Asset Management LP ("**GoldenTree**"), a global asset management firm. Although the parties initially agreed to a purchase price of US\$392.5 million, the purchase price was subsequently increased to US\$429 million following Syncora's receipt of an unsolicited proposal from another buyer. The transaction closed on December 30, 2019. Syncora will distribute proceeds of the sale to shareholders in connection with the company's plan of liquidation, which Syncora announced was approved by shareholders on January 28, 2020. Kuvare US Holdings, Inc. ("**Kuvare**"), a private equity-backed annuity issuer, also sought to accelerate its growth via

*The appetite of private equity and other financial buyers for insurance assets remained very much in evidence in 2019, driven in part by a desire to bring their asset management capabilities to the large pools of assets supporting insurance reserves.*



M&A. The acquisition of Lincoln Benefit Life Company ("**LBL**") by Kuvare (through its subsidiary, Guaranty Income Life Insurance Company) allows Kuvare to continue its rapid growth by adding a third U.S.-based insurance carrier in runoff, which will complement its direct distribution platform.

In an effort to arm itself with on-demand access to equity capital to support M&A, reinsurance and pension risk transfer deals, in May 2019 Athene Holding Ltd. ("**Athene**") announced the formation of a new joint venture capital vehicle, Athene Co-Invest Reinsurance Affiliate ("**ACRA**"), with certain investment funds managed by Apollo Global Management, Inc. ("**Apollo**"). As of the end of 2019, Apollo had raised approximately US\$3.2 billion in capital commitments.

In October 2019, Apollo and Athene entered into an agreement providing for a share exchange transaction pursuant to which Apollo would purchase an 18% incremental stake in Athene and nearly double its economic interest to approximately 35%. As part of the same transaction, Athene would acquire an approximately 7% equity stake in Apollo. The deal closed on February 28, 2020, at which time Athene's multi-class share structure was converted into a single-class share structure. It is anticipated that the restructuring will increase Athene's index eligibility and broaden investor appeal.

#### d. Insurtech

Legacy carriers and startup companies alike continued to demonstrate keen interest in pursuing insurtech transactions in order to expand their data and analytic capabilities. Traditional carriers investing in insurtech have been eager to utilize digitally focused products that make the business of insurance more accessible and efficient. The US\$2.35 billion acquisition by Prudential Financial Inc. ("**Prudential**") of Assurance IQ, Inc. ("**Assurance IQ**") is one such example. Assurance IQ, a direct-to-consumer platform, matches buyers with customized products spanning life, health, Medicare and auto insurance. In addition to upgrading its digital capabilities, Prudential hopes that the transaction will broaden its customer base to a wider portion of the socio-economic spectrum. The transaction includes an earnout of up to US\$1.15 billion in cash and equity, contingent upon Assurance IQ achieving multi-year growth targets.

Other insurtech transactions announced in 2019 included Aon's purchase of CoverWallet, a digital insurance platform for small and medium-sized businesses, and Securian Financial Group, Inc.'s agreement to buy Emphyrean Benefit Solutions, Inc., a platform for employee benefits and human resources administration. The terms of these transactions were not publicly disclosed.

### 3. The Growth of Representations and Warranties Insurance in Insurance M&A

Although representation and warranty insurance ("**RWI**") is not new to dealmakers outside the insurance industry, the use of RWI in insurance M&A has grown significantly as RWI providers become more comfortable underwriting seller representations in insurance transactions, and the initial apprehensions prompted by the relationship between insurance M&A participants and RWI carriers have seemingly abated. Although used widely in divestitures by private equity and other financial sellers disinclined or unable to accept long escrow or indemnification periods, RWI is increasingly a feature even of deals between strategic buyers and sellers who wish to protect themselves from the risk of warranty breaches and streamline the negotiation of M&A purchase agreements. We expect the uptick of RWI in insurance M&A to continue into 2020 and beyond.

#### 4. Outlook

Through the first quarter of 2020, the economic fallout of the COVID-19 outbreak has included the worst weekly decline for the U.S. stock market since the 2008 financial crisis, the largest ever single day point drop in the Dow Jones Industrial Average, "stay-at-home" orders in U.S. jurisdictions covering more than half of the population, a record spike in weekly unemployment insurance claims, historically low interest rates in the U.S., slower economic growth in China and increased downward pressure on global economic growth. While these developments seem likely to have a negative impact on insurance M&A activity, the magnitude and duration of this impact are uncertain.

That said, some of the factors that had propelled insurance M&A dealmaking prior to the outbreak of COVID-19 remain pertinent. In particular, interest rates seem likely to remain low, at least in the near-to-medium term, with the economic impact of COVID-19 exerting significant downward pressure on rates. In addition to macroeconomic factors, industry-specific trends that were apparent pre-pandemic should

*Legacy carriers and startup companies alike continued to demonstrate keen interest in pursuing insurtech transactions in order to expand their data and analytic capabilities.*

*...some of the factors that had propelled insurance M&A dealmaking prior to the outbreak of COVID-19 remain pertinent.*

continue to influence insurance M&A. For example, we would expect interest in insurtech to remain a driver of deal activity as carriers seek innovation and expansion of direct-to-customer distribution channels.

The effect on the insurance M&A space of the recently passed Setting Every Community Up for Retirement Enhancement Act (the “**SECURE Act**”) bears watching. The legislation is intended to reform the ways in which employers offer retirement plans to their employees by liberalizing the market for 401(k) plans. This includes the ability to offer annuities through 401(k) plans and allowing part-time workers to participate. It has been estimated that the SECURE Act could generate US\$1 trillion in account balances during the next four to five years.<sup>3</sup> This could present a number of new opportunities for asset managers and insurers in the years to come.

Insurance M&A may be affected by the growing number of jurisdictions that provide mechanisms for voluntary restructuring of solvent insurers (e.g., insurance business transfers and corporate divisions). While it remains to be seen the extent to which insurers will seek to take advantage of these restructuring mechanisms, Oklahoma became the first insurance department in the U.S. to approve an insurance business transfer in November 2019. See section IV.A.12 below for more detail on these voluntary restructuring mechanisms.

Of course, 2020 also brings its share of challenges to M&A markets, beyond the economic upheaval resulting from COVID-19 noted above. Increasing regulatory scrutiny (particularly from the Committee on Foreign Investment in the United States and antitrust regulators), Brexit, continuing uncertainty in relationships with key international trading partners and turbulence in the wake of U.S. presidential and congressional elections could hamper deal-making prospects. Insurance activity, in particular, may be weighed down by high valuations.

In 2020, shareholder activists may increasingly turn their gaze to the insurance industry, which had traditionally been a less attractive target for activism owing to the regulatory oversight to which insurers are subject. The last year has seen two prominent examples of shareholder activism in the insurance space.

- In May 2019, shortly after acquiring approximately 5.8% of the common stock of Argo Group International Holdings, Ltd. (“**Argo**”), Voce Capital Management LLC (“**Voce**”) nominated five candidates to the Argo board. Argo urged its shareholders to reject Voce’s slate of candidates. Just days ahead of Argo’s annual shareholder meeting in May, Voce announced that it had been advised by Illinois insurance regulators that they would pursue injunctive relief and seek the voiding of any proxy votes cast in favor of Voce’s nominees. Virginia insurance regulators also raised concerns regarding the proxy contest. It appears that the Illinois and Virginia regulators informed Voce that its proxy contest could violate state insurance holding company statutes because Voce’s having representation on the Argo board would give Voce “control” over an insurer. Later in 2019, after Argo’s CEO retired, Voce launched a second proxy contest by calling a special meeting and, on December 31, Argo agreed to put a Voce nominee on the Argo board, subject to regulatory approval. Argo also agreed to consult with Voce on the identification of two more new independent directors in advance of Argo’s 2020 annual shareholder meeting.
- In late February 2020, Third Point LLC (“**Third Point**”), a US\$14 billion asset manager and the second largest shareholder of the UK insurer Prudential plc, urged Prudential plc to separate Prudential Corporation Asia and Jackson National Life Insurance Company into two distinct, publicly traded companies and to focus on reinvesting capital in each unit rather than prioritizing dividend growth. Prudential plc has acknowledged Third Point’s proposal and says that it “looks forward to commencing a dialogue” with Third Point. Whether these events will ultimately be seen as an exception or a turning point, insurance companies will likely devote greater attention to shareholder activism in 2020.

Finally, the U.S. tax reform enacted in late 2017 may continue to influence deal activity in 2020. The U.S. base erosion and anti-abuse tax (“**BEAT**”) aims to disincentivize the transfer of profits overseas. The BEAT rate was 5% in 2018, doubled to 10% in 2019 and will increase to 12.5% for 2026 and beyond. These

<sup>3</sup> US Retirement Savings Reform Could Bring in \$1 Trillion Worth of Balances, S&P Global Market Intelligence.

*In 2020, shareholder activists may increasingly turn their gaze to the insurance industry, which had traditionally been a less attractive target for activism owing to the regulatory oversight to which insurers are subject.*

higher rates could further deter insurance companies from moving business offshore through reinsurance, and M&A participants may seek to develop deal structures that minimize the implications of BEAT with offshore affiliates.

## B. EUROPEAN MARKETS

### 1. Introduction

After a very busy prior year, 2019 saw a relative slowdown in UK and European insurance M&A activity, particularly for higher value and international deals, with uncertainty about the UK's withdrawal from the EU undoubtedly casting a shadow over transaction volumes. Areas that held up relatively well in 2019, being less affected by Brexit headwinds, included smaller/mid-market broker and managing general agent deals, and insurtech transactions. There were also a large number of active processes in 2019 for the sale of Lloyd's of London ("**Lloyd's**") managing agencies; however, relatively few of these resulted in concluded transactions, and none of those that did sign were of the scale of the headline transactions of 2018.

### 2. Lloyd's

Historically, many Lloyd's M&A deals have been driven by buyers drawn by one or more of the advantages of operating a Lloyd's platform (including Lloyd's international licenses, market reputation, financial rating and Lloyd's Brussels as a Brexit solution). However, this more traditional Lloyd's M&A play of acquiring a managing agency to help drive international expansion was not at the forefront of Lloyd's deal activity in 2019. Of the concluded transactions, several involved existing Lloyd's managing agencies (and insurance groups with Lloyd's platforms) acquiring other Lloyd's businesses to drive better economies of scale, one example of which was Arch Capital Group's ("**Arch Capital**") acquisition of Barbican Holdings (including Barbican Managing Agency Limited and Lloyd's Syndicate 1955).

The other main area of Lloyd's M&A activity involved managing agents with syndicates in runoff or whose business plans had been curtailed by the Lloyd's performance review. Bidders for these types of assets tended to be private equity firms looking at Lloyd's as a pure value play around the more distressed targets or runoff consolidators looking to establish or grow a Lloyd's legacy platform. One of the concluded 2019 deals in the latter category was Premia's acquisition of Charles Taylor Managing Agency ("**Charles Taylor**") (including the Standard Syndicate 1884).

However, relatively few of the Lloyd's M&A processes in 2019 resulted in concluded transactions and several managing agents that were the subject of unsuccessful sale processes have since been put into runoff. Aside from there clearly being a mismatch between sellers' expectation on price and what the bidders were prepared to offer, another factor that impacts the current Lloyd's M&A dynamic is the potential impact of the reforms announced in The Future at Lloyd's prospectus.

Historically, the long lead time and associated costs of establishing a Lloyd's platform organically via a turnkey operation has meant that M&A has, for many, been a preferable route to market entry, and has added some level of "market access" premium to the valuations of Lloyd's entities. The Lloyd's prospectus, since expanded upon in Blueprint One — the Future At Lloyd's ("**Blueprint One**"), envisages both simplified methods for enabling third parties to deploy capital in Lloyd's and the concept of a "syndicate in a box" for bringing new products and business into the market (see section IV.C.2 below). This might, in the medium-to-longer term, provide viable alternatives to acquisition for some who might otherwise have looked to acquire a Lloyd's platform, such as private equity firms, insurance-linked securities ("**ILS**") funds and other third-party investors.

### 3. Broker M&A and Private Equity

Consolidation in the UK broker market continued to be a significant trend in 2019. One notable deal was the acquisition by Arthur J. Gallagher & Co. ("**Gallagher**") of UK specialist insurance broker Stackhouse Poland Group Ltd in April 2019. The latter half of 2019 also saw Gallagher announce its intention to increase its stake in Capsicum Reinsurance Brokers from 33% to 100%.

Several of the higher profile broker M&A deals in the last 12 months have involved private equity firms. The private equity arm of Goldman Sachs Group, Inc. acquired a majority stake in UK-based insurance brokerage firm Aston Lark (which specializes in commercial insurance, private client insurance and

*After a very busy prior year, 2019 saw a relative slowdown in UK and European insurance M&A activity, particularly for higher value and international deals...*

*Areas that held up relatively well in 2019, being less affected by Brexit headwinds, included smaller/mid-market broker and managing general agent deals, and insurtech transactions.*



employee benefit advice), in a deal valued at approximately £320 million. Further, private equity investor B.P. Marsh & Partners PLC acquired a 30% stake in Lloyd's marine broker Lilley Plummer Risks Limited and Beech Tree PE LLP announced the acquisition of a majority stake in specialist managing general agent Avid Insurance Services, a Lloyd's broker and coverholder. More recently, Lovell Minnick Partners completed its acquisition of Charles Taylor and Madison Dearborn Partners, LLC and HPS Investment Partners, LLC acquired a majority stake in Irish broker Arachas Corporate Brokers Limited.

The European insurance sector continues to be a source of interest for private equity firms with significant investment funds at their disposal as insurance groups look to divest assets which they no longer consider to be part of their core business. Many private equity firms have seen a chance to acquire these assets and reinvigorate them through more efficient management and wider synergies with their own investment management skill set, in order to drive sustainable profits.

#### 4. Insurtech

In 2019, there was significant growth of investment in established European insurtech startups. Traditional (re)insurance companies have demonstrated a growing interest in investing their capital into insurtech, learning from the ever-increasing influence of fintech in the financial sector and noting the advantages that come from using digital products that make insurance more accessible and more efficient. Taking this in conjunction with the potential increase of market competitors from major technology companies, and startups that seek to disrupt the insurance sector, the major (re)insurers are looking to increase the size and scope of their investments in order to ensure that they do not fall behind.

In 2019, private equity-backed Kingsbridge Group acquired online insurer Dinghy UK Limited, which provides a flexible insurance product that allows customers to adjust coverage, for example, depending on holiday periods. In addition, private equity firm Astorg Partners acquired a minority stake in Acturis Group, a leading supplier of insurance software. Large brokers have also continued to invest in insurtech: as noted above, in 2019 global insurance broker Aon agreed to acquire CoverWallet, an insurance platform for small and medium-sized businesses, in a deal which closed in January this year.

An example of insurtech in the Lloyd's market is the partnering between Parsyl, Inc., a startup data platform, and various Lloyd's syndicates, which involves insurance linked to the coverage 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.

The Lloyd's Lab, initially launched in 2018, continues to provide 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. An example of Lloyd's Lab applying new technology to the insurance sector in 2019 is ClauseMatch Limited, whose policy management solution is designed to use artificial intelligence to help to streamline compliance procedures.

#### 5. Runoff and Restructuring Market

In addition to the transactions in the Lloyd's market in respect of syndicates in runoff, to which reference is made above, there was steady transaction activity in 2019 across both the life and non-life runoff sectors in the UK and Europe. Many deals continue to stem from the capital requirements introduced under Directive 2009/138/EC ("**Solvency II**"). In particular, life and annuities, and products promising guaranteed returns, have become less attractive for insurers as the regulatory framework requires that insurers hold additional capital to match their liability risks. In May 2019, Italian insurer Generali Group signed an agreement to sell the life runoff portfolio of its UK branch to a subsidiary of Reinsurance Group of America Inc. ("**RGA**"). Solvency II capital requirements in respect of longevity risk have also acted as a catalyst for a wide range of longevity swap and single premium life reinsurance transactions (see section III below).

In the non-life runoff sectors, the impact of Solvency II has also resulted in a number of insurers opting to adapt their business models by divesting themselves of legacy books. In July 2019, European insurer DARAG Group Ltd. ("**DARAG**"), a Malta-based legacy acquirer, announced the acquisition of The Underwriter Insurance Co. Ltd., a UK-based insurer in runoff. DARAG also announced in July 2019 that it

entered into an agreement to buy a book of runoff business from One Re Ltd., a London-based non-life reinsurance company. In addition, the sale of RenaissanceRe Holdings Ltd.'s UK legacy portfolio to AXA Liabilities Managers is expected to close in 2020, subject to regulatory approval.

## 6. Other Insurance Company Transactions

In 2019, Athora Group announced its plan to acquire VIVAT N.V. ("**VIVAT**"), the fourth-largest insurer and second-largest life insurer in the Netherlands, in a deal which is expected to close in 2020. Other significant recent European insurance M&A transactions include Helvetia Holding AG agreeing in January 2020 to acquire a 70% majority stake in Caser Seguros SA for £657 million, and in February 2020 UNIQA Insurance Group AG agreed to acquire AXA's operations in Poland, the Czech Republic and Slovakia for £850 million.









## II. The Global Alternative Risk Transfer and Capital Markets

### A. LIFE AND 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. Principles-Based Reserving Now Operative

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 National Association of Insurance Commissioners (the "**NAIC**") provided for a three-year transition period during which life insurers could, but were not required to, implement PBR. Beginning January 1, 2020, PBR became mandatory for all insurance companies.

##### b. Current State of SSAP 41R Clarifying Revisions

As discussed in last year's edition of the *Sidley Global Insurance Review*, at the March 2018 meeting of 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 nonsubstantive) 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. Upon receipt of additional feedback from interested parties, the NAIC staff determined that more information regarding "linked surplus notes" was needed before any further action was taken with regard to the proposed revisions to SSAP 41R. Following a regulator-only conference call on July 2, 2019 with the SAP Working Group and discussions among interested parties at the August 2019 NAIC meeting, the SAP Working Group recommended that the NAIC staff and the SAP Working Group cooperate with interested parties to establish terms and guidelines for a data call whereby reporting companies would provide the NAIC staff with information surrounding their use of "linked surplus notes." As of this writing, the NAIC is working with industry representatives to determine parameters for such a data call in 2020.

##### 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

*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...*

*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...*

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, Connecticut, 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 (“**SVO**”)), 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

Existing trends in the Regulation XXX/Regulation AXXX market continued to hold true in 2019. Like previous years, we understand that the majority of the deals that were completed in 2019 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 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 2019 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 remain nonrecourse to the ceding company or its affiliates.

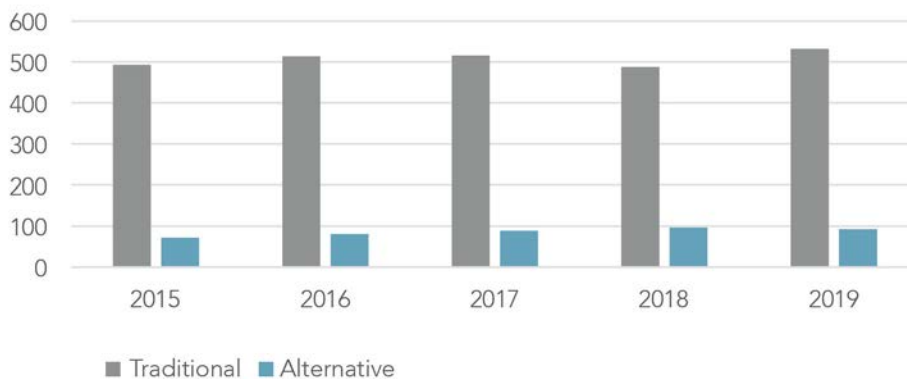
We have also found that in the post-AG 48 market, Regulation XXX/Regulation AXXX transactions must address possible shortfalls in Primary Security. The penalty for failing to fully collateralize Primary Security is that the ceding company’s credit for reinsurance will be reduced to the amount of Primary 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 once again demonstrated ART’s importance and resilience as an alternative to traditional capital models. Even though alternative reinsurance capital levels remained constrained due to the continued impact of record-breaking losses from 2017 and 2018 catastrophe events and trapped collateral related thereto, alternative reinsurance capital, in the form of catastrophe bonds, reinsurance sidecars and other ILS, industry loss warranties (“**ILWs**”) and collateralized reinsurance, managed to grow to approximately US\$93 billion as of the end of 2019, representing approximately 15% of the estimated US\$625 billion total capital dedicated to global property catastrophe reinsurance.<sup>4</sup> The following provides an overview of the global P&C ART market’s highlights and trends of 2019 and outlook for 2020.

*The extensive use of alternative risk transfer (“ART”) products in the P&C market once again demonstrated ART’s importance and resilience as an alternative to traditional capital models.*

Global Traditional and Alternative Reinsurance Capital  
(US\$ billions)



Source: *Reinsurance Market Outlook*, Aon Benfield (January 2020).

### 1. Catastrophe Bonds

The volume of new 144A catastrophe bond issuance fell significantly in 2019 from approximately US\$10 billion in 2018 to about approximately US\$6 billion in 2019 (excluding mortgage ILS deals). Deal flow was particularly slow in the first three quarters of 2019, but picked up significantly in the fourth quarter of 2019 with approximately US\$2.5 billion of new issuances. This uptick has continued into the first quarter of 2020, and many are predicting a very productive year for catastrophe bonds in 2020, with predictions ranging from around US\$8 billion to US\$11 billion of new issuances.<sup>5</sup> However, despite the strong start to 2020, the major financial upheaval to the global markets caused by the COVID-19 outbreak has added significant uncertainty, and it is yet unknown how this will affect the catastrophe bond market.

The low issuance volume of 144A catastrophe bonds in 2019 may be due to several factors, including the low volume of deals maturing relative to previous years and the fallout from the increasing losses and loss reserves arising from the significant 2017 and 2018 catastrophe events. With investors being more cautious following these 2017 and 2018 losses and there being less available capital, catastrophe bond pricing generally increased in 2019 but softened towards the end of 2019.

Despite the lower issuance volume, innovative deals still made their way into the market in 2019. For example, the fourth quarter of 2019 saw a mortgage-focused investment manager obtain US\$225 million of protection against earthquakes for its portfolio of mortgage-related securities through the Sierra Ltd. catastrophe bond, marking the first time a catastrophe bond was used for this particular purpose. The fourth quarter of 2019 also saw the government of the Philippines obtain US\$225 million of protection

*....many are predicting a very productive year for catastrophe bonds in 2020, with predictions ranging from around US\$8 billion to US\$11 billion of new issuances.*

*With investors being more cautious following these 2017 and 2018 losses and there being less available capital, catastrophe bond pricing generally increased in 2019 but softened towards the end of 2019.*

*Despite the lower issuance volume, innovative deals still made their way into the market in 2019.*

<sup>4</sup> *Reinsurance Market Outlook*, Aon Benfield (January 2020).

<sup>5</sup> See, e.g., <https://www.artemis.bm/reinsurance-sidecars/>.



against earthquakes and tropical cyclones in a bond offering by the World Bank (International Bank for Reconstruction and Development). This issuance was the first catastrophe bond transaction to be listed on the Singapore Exchange and the first to be sponsored by an Asian sovereign.

Privately placed catastrophe bond transactions, known as “cat bond lites,” surpassed US\$900 million for the third consecutive year with a record 29 transactions in 2019.<sup>6</sup>

## 2. Market Response to Recent Catastrophe Losses

Global insured catastrophe losses in 2019 (including losses from Hurricane Dorian, Typhoons Hagibis, Faxai and Lekima, Monsoon Floods in China, and Mississippi and Missouri Basin Floods) totaled US\$71 billion, 6% above the 21st century annual average (US\$67 billion).<sup>7</sup> Although significantly lower than 2017’s record-breaking US\$157 billion of insured losses and 2018’s US\$100 billion of insured losses, global insured catastrophe losses in 2019 were still 6% above the 21st century annual average (US\$67 billion).<sup>8</sup> Three consecutive years of above average catastrophe losses have impacted market capacity, pricing and terms. The retrocession market in particular has experienced increased pricing for retrocessional protection and tighter coverage terms. Adverse loss development with respect to 2017 and 2018 losses and trapped collateral related to 2017 and 2018 losses constrained alternative reinsurance capital levels going into 2020. Social inflation (an increase in insurance losses caused by factors such as greater frequency of litigation, more liberal definitions of liability, more plaintiff-friendly legal decisions and higher jury awards) has contributed to this adverse loss development, forcing reinsurers and alternative capital providers to consider how to appropriately price risk to take into account social inflation. A significant divergence of performance persists among players in the reinsurance market, with some showing strong profitability while others fail to cover their cost of capital, leading to withdrawal of treaty capacity in some instances.

Despite loss experience in the past three years, some ILS funds managed to raise fresh capital for the January 2020 renewals and some new ILS platforms were launched. ILS fund manager Tangency Capital Ltd., which focuses on quota share reinsurance, increased its assets under management by 50% from July 2019 to January 2020 to around US\$400 million.<sup>9</sup> In January 2019, PIMCO launched its P&C ILS business, in partnership with its parent, Allianz SE.

## 3. Sidecars

In 2019, 20 sidecar issuances<sup>10</sup> came to the market, totaling over US\$4 billion and proving to be a continued source of strategic value to (re)insurers. A number of existing sidecar vehicles returned to the market in 2019, including Harambee Re Ltd. (sponsored by Argo), K Cession (sponsored by Hannover Re) and Versutus Ltd. (sponsored by Brit Ltd). Many of these issuances covered new regions, perils and lines of business. In addition, a number of new sidecar vehicles came to the market in 2019, including 157-Re (sponsored by CCR Re SA), Sector Re Ltd. (sponsored by Swiss Re Group), Turing Re Ltd. (sponsored by Hamilton Re) and Voussoir Re Ltd. (sponsored by Arch Capital). In early 2020, issuances by eight sidecars came to the market, one of which was Lion Rock Re II, the second issuance sponsored by Peak Reinsurance Company Limited, which became the first ever Asian sidecar sponsor in December 2018. Several of the new sidecars that entered the market in 2019 were also renewed in early 2020.

## 4. Global ILS Initiatives

Bermuda continued to be the preferred Special Purpose Insurer (“**SPI**”) domicile with 19 issuances by Bermuda SPIs in 2019. In August 2019, the Bermuda Monetary Authority (“**BMA**”) adopted the Amendment Act 2019, which provides for, among other things, the supervision and regulation of a new class of “Collateralised Insurer.” The BMA created the new “Collateralised Insurer” class to address the

<sup>6</sup> *Cat Bond Lites are Growing in Number and Importance*, Artemis, February 6, 2020.

<sup>7</sup> *Weather, Climate & Catastrophe Insight – 2019 Annual Report*, Aon Benfield (January 2020); *Reinsurance Market Outlook*, Aon Benfield (January 2020).

<sup>8</sup> *Weather, Climate & Catastrophe Insight – 2019 Annual Report*, Aon Benfield (January 2020); *Reinsurance Market Outlook*, Aon Benfield (January 2020).

<sup>9</sup> *ILS capacity constraints continue, but not for everyone*, February 3, 2020, Artemis.

<sup>10</sup> See <http://www.artemis.bm/reinsurance-sidecars> for full list.

ways in which the SPI structure has been utilized to include transactions for which it was not originally intended. According to the BMA, this new class will support collateralized reinsurance in a more flexible and appropriately regulated manner.

Other jurisdictions are also attracting ILS investors and taking steps to create further market opportunities. Five of the 29 privately placed issuances in 2019 were issued by Cayman Islands-domiciled SPIs and two were issued by Irish SPIs. With the establishment of a new regulatory regime in December 2017 (as described in more detail below in section II.C), the UK ILS market continued to grow in 2019 with two ILS transactions issued by UK-domiciled SPIs.

In its continuing bid to become an ILS domicile for the Asian region and beyond, the Monetary Authority of Singapore ("**MAS**") introduced a new initiative to attract issuers and catalyze the ILS market in Singapore. In January 2018, MAS introduced an ILS grant scheme, which offers to fund up to 100% of the upfront issuance costs of an ILS bond issuance out of Singapore. Qualifying issuers may be first-time issuers or non-bank financial institutions with an Asian nexus. Since the introduction, several catastrophe bonds have been issued out of Singapore.

The Philippines government has also taken steps to expand the role of insurance and reinsurance markets in addressing the catastrophe risk facing the country. The Insurance Commission of the Philippines entered into a Memorandum of Understanding with the Philippine Insurers and Reinsurers Association and reinsurer National Reinsurance Corp. of the Philippines ("**NatRe**") to establish a catastrophe risk pooling facility that would pool catastrophe risk and cede it to NatRe, as well as potentially the global property reinsurance markets.

In the U.S., in May 2019, the California Senate passed California Bill SB 290, which would allow the California Office of Emergency Services to work with the California treasurer and the California insurance commissioner to purchase insurance, reinsurance and other related alternative risk transfer products. The bill received unanimous support from the key Assembly Insurance Committee. However, in August 2019, the bill stalled as the Department of Finance of California and a consumer organization raised objections to the way the bill exempts the purchase of such insurance and financial products from normal state oversight. The bill was pulled from the legislative calendar and has been suspended by its sponsors.

## 5. M&A Activity

In 2019, M&A continued to be one of the main drivers behind the continued convergence of traditional insurance and reinsurance with the ILS market. According to S&P Global Ratings ("**S&P**"), due to the continued pressure on the reinsurance sector's earnings, (re)insurers have looked to M&A to strengthen their business and financial positions. S&P expects that challenging business conditions and the availability of inexpensive financing in the debt markets will continue to fuel M&A activity for the next few years. A number of deals that took place in 2019 provide evidence of such convergence. In May 2019, White Mountains Insurance Group purchased a 30% stake in Elementum Advisors, LLC ("**Elementum**"), a Chicago-headquartered ILS investment management company, for US\$55 million. In September 2019, SCOR Investment Partners, the investment arm of reinsurance giant SCOR SE ("**SCOR**"), acquired 100% of Coriolis Capital Limited ("**Coriolis**"), one of the longest-standing ILS fund managers, for an undisclosed amount. Coriolis is based in London and has approximately US\$800 million of ILS and reinsurance-linked assets under management. SCOR Investment Partners viewed this transaction as a way to accelerate its development in the ILS market.

## 6. Outlook Ahead

As in 2019, 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, despite capital constraints experienced in 2019 as a result of significant catastrophe losses in recent years.

We expect that traditional insurers and reinsurers will continue to explore new ways to use third-party capital to their benefit. In addition, we expect that the ILS market will continue to look for new and innovative ways to meet the needs of cedants and investors.

## C. PRUDENTIAL REGULATION AUTHORITY CONSULTS ON UPDATES TO THE UK'S ILS REGIME

The UK's ILS regime has been in force since December 2017, with the Risk Transformation Regulations 2017 (the "**Regulations**"), which set out the corporate and regulatory legislative structure for the UK's ILS regime, and the Risk Transformation (Tax) Regulations 2017 (the "**Tax Regulations**"), which set out the tax legislative structure. In addition, the Prudential Regulation Authority ("**PRA**") published the final version of an amended PRA Rulebook, including new rules to incorporate the ILS regime, as well as a Supervisory Statement<sup>11</sup> ("**SS8/17**"), setting out its guidance on the new rules and regulations, and the Financial Conduct Authority ("**FCA**") published its final statement on authorizing and supervising special purpose vehicles for ILS.

Since the regime has come into force, the UK regulators have already approved a number of ILS structures. With the experience gained from this, the PRA committed as part of its 2019/2020 Business Plan to further refine the ILS framework. As part of this commitment, the PRA released, in September 2019, Consultation Paper CP19/19 entitled *Insurance special purpose vehicles: Updates to authorization and supervision* ("**CP19/19**") that aims to provide further clarity on the PRA's approach and proposed developments in relation to the authorization and supervision of insurance special purpose vehicles ("**ISPVs**"). While the Solvency II requirements applicable to ISPVs have not changed since the UK's implementation of the ILS regime, the proposals contemplated in CP19/19 reflect the PRA's and applicants' experience gained over this period.

The main focus of CP19/19 is to provide updates to SS8/17, as well as certain changes to the ISPV part of the PRA Rulebook and changes to the Multi-arrangement Insurance Special Purpose Vehicle ("**MISPV**") New Risk Assumption Notification Form. The consultation period ended on December 3, 2019. Following this, and any time taken to consider the responses, the PRA is intending to publish a final policy, which will set out the final changes proposed.

### 1. Proposals Regarding Funding Arrangements

The PRA is proposing to include additional details in the "funding arrangements" section of SS8/17. Solvency II requires that ISPVs remain fully funded at all times,<sup>12</sup> which means that market participants operating under the UK ILS regime are not able to take advantage of "rollover" techniques used in some other jurisdictions, which allow ILS vehicles to use or roll over the funding from the current risk year into the following risk year. This can be problematic for ILS participants, as it can be difficult to obtain commitments from investors to effectively provide double the funding to cover both risk periods.

Accordingly, the PRA is aware that ILS market participants are keen to understand the ways in which the use of techniques such as the "roll over" of funding might be implemented in the UK in a manner that is compliant with Solvency II. Other jurisdictions, such as Guernsey, are clarifying this point to assist market participants. The Guernsey Financial Services Commission ("**GFSC**") announced in late 2018 that it would allow a 30-day grace period at the beginning of a transaction, or at its renewal, where an ILS cell will not be considered to be in breach of the requirement to be fully funded if the collateral is not fully in place yet. This change in regulation has been well received in the market, as it provides clarity to market participants operating in Guernsey that they will not be penalized if they are not fully funded at the start or renewal phase of a transaction, and therefore that techniques such as "rollover" can be used.

In the proposed updates to SS8/17, the PRA has added the following as examples of mechanisms that might have the effect of "rolling over" funding: "deferral of premium payments, funding top-ups, delayed risk period inception, or mechanisms that allow the "roll over" of funding between two consecutive risk transfer arrangements." While this indicates that the PRA is open to conversations around differing mechanisms to "roll over" funding, the PRA makes it clear in the proposed new paragraph 3.19A of SS8/17 that, where firms wish to "roll over" funds, funds being held to meet the Aggregated Maximum Risk Exposure<sup>13</sup> ("**AMRE**") of one risk transfer arrangement should not, simultaneously, be used to meet the AMRE of a new risk transfer arrangement.

<sup>11</sup> Supervisory Statement (SS)8/17 *Authorisation and supervision of insurance special purpose vehicles*.

<sup>12</sup> Article 319 of the Solvency II Delegated Regulation.

<sup>13</sup> As defined in Article 1(44) of the Commission Delegated Regulation (EU) 2015/35.

This therefore confirms that from the PRA's perspective, ILS structures must be fully funded for both risk periods in a renewal situation, and the PRA has not elected to implement legislation similar to Guernsey in this context. However, unlike the UK, Guernsey is not constrained by Solvency II requirements, making it easier for Guernsey (and other ILS jurisdictions like it) to legislate to allow ILS structures to benefit from the use of "rollover" mechanisms. It is likely that the constraints Solvency II poses on the UK in this regard will continue to adversely impact the growth of UK ILS market.

## 2. Proposals Regarding "Documentation Requirements"

The PRA is proposing to revise its expectations in relation to the documentation that is required to be provided as part of the application process. As noted in the current version of SS8/17, the PRA expects final transaction documentation to be submitted where possible, and if final documentation is not available, then drafts should be submitted. However, the PRA now recognizes that in certain circumstances, a complete set of final documentation or drafts of documentation may not be available at the time the applicant wishes to submit its application. Accordingly, the PRA has indicated that applicants should aim to engage with the PRA to agree what information is likely to be available and how this may impact the timing of the application.

The PRA is also proposing to change its approach regarding the requirement for applicants to submit an independent third-party opinion. In the current version of SS8/17, while not a formal requirement, the PRA notes that it may be useful for applicants to include a third-party opinion with the application. However, the PRA is now proposing that it will not expect applicants to submit such opinions in every case (for example, in the case of a straightforward application), but that it may require a third-party opinion in certain more complex cases that contain novel features. The PRA has included in the draft update to SS8/17 some examples of cases where an independent third-party opinion might be required, such as where a transaction includes complex trust or security arrangements, or where the ISPV invests in non-standard assets. In addition, the PRA notes that a foreign legal opinion will be required where the contractual arrangements are subject to foreign law.

## 3. Proposals Regarding Risk Transfer Requirements

The PRA is proposing to include a new section in Chapter 3 of SS8/17, which outlines its expectations in relation to risk transfer requirements.

The PRA's proposals set out a summary of the applicable Solvency II requirements, as well as the PRA's expectations in relation to demonstrating compliance with these. Such expectations include providing details of the proposed risk transfer in the application form, and a clear demonstration of how the risk transfer arrangements comply with the Solvency II requirements. In addition, the PRA has made it clear that where a risk transfer case includes non-indemnity triggers, specific details of the structure of those triggers should be included in the application.

The PRA is proposing to include this new section to assist applicants in better understanding how they can show compliance with the Solvency II risk transfer requirements as part of the application process.

## 4. UK ILS Outlook

At least in part reflecting the absence of "rollover" mechanisms under the current UK regime, there were relatively few ILS transactions approved under the UK regime over the course of the last year. Of those that did come to market, the more notable deals include the following.

In February 2019, Pool Reinsurance Company established a UK-domiciled and regulated ILS vehicle, Baltic PCC Limited ("**Baltic PCC**"). Baltic PCC launched a terrorism catastrophe bond, which is the first terrorism catastrophe bond to be issued and only one of a small number of terrorism ILS transactions to be issued.

SCOR also launched a second UK-domiciled ILS transaction in June 2019. A new vehicle, Atlas Capital UK 2019 PLC, was established for this transaction, which involved the establishment of a new catastrophe bond to provide multi-year risk transfer capacity of US\$250 million to protect against named storms in the U.S., earthquakes in the U.S. and Canada, and windstorms in Europe. SCOR launched its first catastrophe bond using the UK's ILS regime in 2018.



As for 2020 and beyond, market participants will no doubt be interested to see what the PRA may propose as a result of the feedback it receives on CP19/19, particularly in relation to “rollover” mechanisms. However, given the current Solvency II constraints requiring ISPVs to be “fully funded” at all times, it is perhaps unlikely that any solutions proposed by the PRA at this stage will afford the same level of flexibility as other ILS jurisdictions that are not so constrained.

Looking further ahead, once the UK is no longer within the transition period and therefore no longer subject to European legislation, there will be scope for the UK to legislate away from the position under Solvency II. Accordingly, in the medium term there may be more scope for changes to the existing UK ILS regime that would, in turn, make it a more favorable jurisdiction for the ILS market.

#### D. TRADITIONAL CAPITAL MARKETS

The year saw significant activity in initial public offerings (“**IPOs**”) in the insurance industry, including two significant transactions in connection with insurer conversions from a reciprocal exchange or mutual to stock form. The pace of capital markets transactions also remained strong throughout 2019 for traditional debt offerings and note issuances.

In March, Positive Physicians Holdings, Inc. (“**PPH**”), a provider of medical malpractice insurance, completed its IPO of 3,615,500 shares at a per-share price of US\$10. In connection with the IPO, three reciprocal insurance exchanges were converted into stock insurance companies and merged to form Positive Physicians Insurance Company, a wholly owned subsidiary of PPH.

In August, life insurer Vericity, Inc. (“**Vericity**”) completed its IPO of 14,875,000 shares at a US\$10 per-share price. Vericity’s IPO was conducted in connection with the conversion of Members Mutual Holding Company (“**Members Mutual**”) from mutual to stock form and the acquisition by Vericity of all of the capital stock of Members Mutual following its conversion.

Other notable insurance IPOs include Palomar Holdings, Inc., an insurer offering specialty property and personal insurance focused on earthquake, wind and flood coverage, which debuted in April with an IPO of 5,630,000 shares at US\$15 per share (with an additional 843,750 shares made available to underwriters). ProSight Global, Inc., a P&C insurance company, went public in July, offering 7,800,000 shares at US\$14 per share. In October, insurance distributor BRP Group, Inc. raised US\$230 million in its IPO of 16,400,000 shares at a per-share price of US\$14.

Insurance companies also continued to raise funds via traditional debt offerings, typically in the form of senior note offerings. In January, Liberty Mutual Group Inc. issued US\$1 billion of 4.569% senior notes due 2029 in exchange for three series of its outstanding senior notes maturing between 2021 and 2023. In May, RGA issued US\$600 million of 3.90% senior notes due 2029, using the proceeds in part to repay its 6.45% senior notes maturing in November 2019. In June, CNO Financial Group, Inc. (“**CNO**”) issued US\$500 million of 5.25% senior notes due 2029. The proceeds of the issuance were used in part to repay outstanding amounts under CNO’s revolving credit facility and redeem its outstanding 4.50% senior notes due 2020.

In August, The Hartford Financial Services Group, Inc. (“**The Hartford**”) issued US\$600 million of 2.80% senior notes due 2029 and US\$800 million of 3.600% senior notes due 2049. The proceeds of the offering were used to pay for a concurrent tender offer for The Hartford’s 5.125% senior notes due 2022 and for the 5.75% senior notes due 2023 issued by The Hartford’s wholly owned subsidiary, The Navigators Group, Inc. Also in August, Lincoln National Corporation (“**Lincoln**”) issued US\$500 million of 3.05% 10-year fixed-rate senior unsecured notes, using the proceeds to fund a tender offer of Lincoln’s 6.15% senior notes due 2036 and its 4.85% senior notes due 2021, as well as repayment of Lincoln’s US\$300 million 6.25% senior notes due 2020. In November, life insurance holding company SBL Holdings, LLC issued US\$500 million of 5.125% senior notes due 2026, with proceeds going towards repayment of the company’s term loan and a portion of outstanding indebtedness under a revolving credit facility.

*The year saw significant activity in initial public offerings (“IPOs”) in the insurance industry...*

*The pace of capital markets transactions also remained strong throughout 2019 for traditional debt offerings and note issuances.*

*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...*

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. In 2019, the usual participants in the funding agreement-backed notes market were seen (which include Metropolitan Life Insurance Company (“**MetLife**”), New York Life, Massachusetts Mutual Life Insurance Company (“**MassMutual**”) and Principal Life Insurance Company), as well as the life insurance companies that entered (or re-entered) the market in the past few years (which include AIG, Athene, Reliance Standard Life Insurance Company, Protective Life Corporation and The Guardian Life Insurance Company of America).

The U.S. Securities and Exchange Commission (the “**SEC**”) Staff (the “**Staff**”) have provided comment letters to insurance companies, or with respect to insurance company transactions in 2019, focusing on the following areas:

- **Revenue Recognition.** The new revenue standard under ASC 606, which took effect on January 1, 2018, requires increased disclosure compared to prior guidance. The Staff has continued to focus on how companies identify performance obligations in contracts with customers and how these conclusions are supported where the relevant goods and services are not separately identifiable. The Staff’s comment letters with respect to revenue recognition have also continued to address areas of judgment, including determinations with respect to transaction price, when a transfer of control occurs, appropriate capitalization and method of revenue recognition over time.
- **Non-GAAP Measures.** The Staff continues to closely scrutinize non-GAAP financial measures and provide guidance regarding the use of such measures, as well as patrol compliance with the Non-GAAP Financial Measures Compliance and Disclosure Interpretations, updated in May 2016. The Staff has increasingly scrutinized non-GAAP measures for individually tailored accounting principles that have the potential to misrepresent the registrant’s financial position, and has questioned the way non-GAAP measures are presented, particularly where non-GAAP measures are featured more prominently than GAAP measures.
- **Management’s Discussion and Analysis.** The Staff has emphasized disclosure requirements related to performance indicators and results of operations (including significant events or economic changes), accounting estimates and judgments in accounting policies and liquidity and capital resources, including uncertainties with respect to a company’s ability to meet cash flow requirements.





### III. The Global Longevity Market

The two principal sources of longevity risk are defined benefit pension schemes and books of annuity business written by life insurers. There have continued to be high levels of transactional activity in both areas, driven by the favorable financial positioning of many pension schemes, the development of alternative de-risking options and many Europe-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 slowdown 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.

#### 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. Buyouts

A pension buyout 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 buyout, there is a direct insurance contract between the insurer and the individual scheme member; and in the event of a full buyout, 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 buyout 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 buyout. 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 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 offshore) are used to convert the derivative exposure into insurance risk that can then be reinsured.

*There have continued to be high levels of transactional activity in both areas...*

*...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.*





Whereas buy-ins and buyouts 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 buyouts, 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 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 led to a record-breaking year for pension de-risking transactions in 2019. According to the LIMRA Secure Retirement Institute, single-premium pension buyout sales in the U.S. in 2019 totaled US\$28 billion, topping the same period in 2018 by approximately 5%.

Defense and aerospace company Lockheed Martin Corp. ("**Lockheed Martin**") was a major player in the pension de-risking market, participating in three transactions totaling US\$3.4 billion. In January, Lockheed Martin purchased group annuity contracts from (i) Pru for US\$1.8 billion, affecting approximately 32,000 U.S. retirees and beneficiaries and (ii) Athene for US\$800 million, affecting approximately 9,000 U.S. retirees and beneficiaries. Lockheed Martin ended the year with the purchase of a third group annuity contract from MetLife affiliate Metropolitan Tower Life Insurance Co. to transfer US\$1.9 billion in pension liabilities, affecting the benefits of approximately 20,000 U.S. retirees and beneficiaries.

In its fourth pension de-risking transaction, AK Steel Holding Corp. ("**AK Steel**") purchased a group annuity contract from MassMutual to transfer approximately US\$615 million in pension liabilities. AK Steel previously completed two buyouts with an undisclosed insurance company in 2016, and in 2018 transferred approximately US\$280 million in pension liabilities, also to MassMutual.

Other notable pension de-risking transactions include healthcare company Baxter International's transfer to Pru of US\$2.4 billion in U.S. pension plan liabilities for approximately 17,200 retirees and beneficiaries, as well as the transfer from Weyerhaeuser Co., a timberland company, to Athene of approximately US\$1.5 billion in U.S. pension plan liabilities affecting approximately 28,500 U.S. retirees and beneficiaries.

Given the recent growth of the longevity market, many insurers in this space have increasingly worked with reinsurers to transfer pension liability risk, either by packaging reinsurance as part of a pension de-risking deal or by obtaining reinsurance for its liabilities after the fact. For smaller insurance companies, working with reinsurers has the potential to strengthen the insurer's balance sheet and increase capacity, allowing it to become a more marketable player in the risk transfer market. Reinsurers, in turn, are attracted by the diversification opportunities that come with participation in pension de-risking transactions. This trend is likely to grow as new players and current participants seek to establish or solidify their foothold in this space.

*Beginning with the GM and Verizon deals in 2012, the pension de-risking market in the U.S. experienced significant growth.*

*The increase in interest and market participants led to a record-breaking year for pension de-risking transactions in 2019.*

*Given the recent growth of the longevity market, many insurers in this space have increasingly worked with reinsurers to transfer pension liability risk...*

*This trend is likely to grow as new players and current participants seek to establish or solidify their foothold in this space.*

The expansion of the pension de-risking market, however, has recently faced regulatory hurdles in the form of investigations by the New York State Department of Financial Services ("**NYDFS**"), into the facilitation by life insurers and insurance brokers of the solicitation or negotiation of annuity pension risk transfer business in New York by unauthorized insurers. For a more detailed discussion, please see section IV.A.2.d below.

### C. UK/EUROPEAN MARKETS

Last year saw a record year for the UK's pension risk transfer market according to industry commentators, with buy-ins, buyouts and longevity swaps totaling almost £50 billion, nearly double the sum reported from the previous year and exceeding industry predictions. The largest UK buyout deal in 2019 was understood to be telent's £4.7 billion buyout with Rothesay Life Plc ("**Rothesay Life**"), reportedly the largest full scheme buyout undertaken in the UK. Other notable deals include Rolls-Royce UK Pension Fund's £4.6 billion buyout with Legal & General Group Plc, Allied Domecq Pension Fund's £3.8 billion buy-in with Rothesay Life and British American Tobacco UK Pension Fund's £3.4 billion buy-in with Pension Insurance Corporation plc ("**PIC**"). Dresdner Kleinwort's £1.2 billion deal with PIC stirred interest as the buy-in of the pension scheme's defined benefit ("**DB**") plan was extended to include the pension scheme's defined contribution ("**DC**") fund, allowing members of the hybrid scheme the option to take their DC savings or convert them into a DB equivalent in order to be transferred. Other large pension schemes such as Marks and Spencer Pension Trust Limited and National Grid U.K. Pension Scheme have been de-risking in portions, choosing various insurers for multiple buy-ins throughout the year.

Market commentary forecasts the continuation of a busy market in 2020, with some consultants boldly suggesting that the total for the next decade could be quadruple that of the previous decade, averaging over £50 billion in transactions a year. Factors that might contribute to this growth include the ongoing maturing of the DB sector leading to reduced prices as the length of insurance contracts decline and, importantly, increased capacity as more reinsurers enter the UK market.

The UK longevity market continued to witness notable transactions in 2019. Market commentary suggests that longevity swap pricing was at its lowest levels in a decade, encouraging participants to hedge risk. June saw a £7 billion longevity swap between HSBC Bank (UK) Pension Scheme and Pru, widely reported as the second largest ever in the UK. In December, Zurich Insurance Group and Hanover Re completed a longevity swap covering around £800 million of pensioner liabilities for a FTSE 100-sponsored pension scheme. Also in December, Athene reinsured US\$818 million in pension risk transfer obligations through its subsidiary, Athene Life Re International Ltd., marking its first deal of this kind in the UK marketplace. Gauging the full size of the market and the number of transactions in any given year remains hampered by the fact that a number of significant transactions are not publically announced, particularly as between life insurers and reinsurers.

We also saw a continuation of the trend that first emerged in 2015 in anticipation of Solvency II coming into effect: the increase in the number of UK and continental European life companies buying longevity protection in the form of reinsurance. This demand has been driven by a number of factors, but perhaps the most significant for life (re)insurers with term life books is that longevity risk acts as a natural hedge against mortality exposure and can create diversification benefits for regulatory capital purposes. Over the course of 2019 and into 2020, we have begun to see an increase in activity in the market in the Netherlands. VIVAT and Canada Life Reinsurance signed a longevity reinsurance deal reported to be valued at €5.5 billion. Canada Life Reinsurance also entered into a longevity reinsurance agreement with Aegon N.V. ("**Aegon**") to cover €12 billion in longevity exposure, which market commentators believe accounts for one quarter of Aegon's longevity exposure in the Netherlands. The Dutch branch of The Chemours Company reportedly transferred €820 million of pension rights to Nationale-Nederlanden N.V. in 2019 and intends to transfer a further €330 million of assets to Centraal Beheer.

As Piggott & Walker argue in an article published in the *British Actuarial Journal* last year, within a European context, only the UK and Holland currently have the conditions for a longevity risk transfer market to develop: low interest rates which, by increasing the present value of more distant pension payments, have exposed the real extent of longevity risk in pension plans; inflation uplifting of pensions in payment further increasing longevity risk; frequent updating by the actuarial profession of longevity projections; the introduction of market-consistent valuation methods; increased accounting transparency of pension assets and liabilities; and increased intervention powers by the regulator.

*Last year saw a record year for the UK's pension risk transfer market according to industry commentators, with buy-ins, buyouts and longevity swaps totaling almost £50 billion, nearly double the sum reported from the previous year and exceeding industry predictions.*

*Market commentary forecasts the continuation of a busy market in 2020...*

*...longevity swap pricing was at its lowest levels in a decade, encouraging participants to hedge risk.*

Some commentators consider that pension schemes have seen a reduction in their desire to hedge longevity risk because most have seen reduced life expectancy since 2011, decreasing their liabilities by 4-5% according to market commentary. There are numerous theories to explain this reduction, including the slowdown in improvements for the treatment of respiratory, cancer and circulatory diseases and an increase in the number of deaths from nervous diseases, such as Alzheimer's and dementia. However, market commentators indicated that last year saw below-average numbers of deaths and significant improvements in mortality rates. This indicates that when the Continuous Mortality Investigation publishes its projection models in 2020, we may see an increase in life expectancy. It remains to be seen whether the change in trend in 2019 was a one-off or a turning point in the statistics.

Market commentators are predicting a significant year for the longevity swap market, with the potential for more swaps than ever before. There may also be an increase in longevity hedges being converted into buy-ins, as seen with Scottish Hydro-Electric Pension Scheme completing such a transaction with PIC in 2019, insuring a reported £750 million worth of liabilities.

Having previously commented on UK longevity market trends, David Rule, Executive Director of Insurance Supervision at the PRA, in a speech labeled as "Part 2" to his speech the previous year at the Westminster and City Annual Conference on bulk annuities, highlighted that UK and European insurers are reinsuring longevity risk on business offshore in response to what he considered was a "significant flaw" of the Solvency II risk margin being too sensitive to interest rates. The PRA does not currently see a durable way to implement a change in the risk margin with sufficient certainty for insurers to be able to rely on it for pricing, capital planning and use of reinsurance, although it is keeping this position under review. Rule also noted that the PRA considers that the availability of longevity reinsurance has limited any drag on growth in the bulk purchase annuity market, although one possible effect has been to make it more expensive for pension schemes with a high proportion of younger members to achieve an insurer buyout, since reinsurers have typically had a lower appetite for deferred rather than in-payment annuities.

In March 2018, the UK Department for Work and Pensions ("**DWP**") published a white paper that introduced superfunds as an alternative to complete risk transfers by traditional buy-ins and buyouts. The superfunds may create competition for insurance companies, as they will likely be regulated by The Pensions Regulator rather than Solvency II and potentially have lower capital requirements. This means that companies would be able to transfer schemes to superfunds at a lower cost than a buy-in or buyout.

At present, the regulatory framework for superfunds is in limbo. In December 2018, the DWP published a consultation on the consolidation of defined benefit schemes, which provided guidelines as to the likely future rules that will regulate the operation of superfunds. However, as of yet there has been no formal framework established. There has been tension between government and industry regulators such as the PRA, which is concerned that unless strong regulations are put in place (particularly in relation to capital adequacy), superfunds could pose a significant risk to the UK pensions safety net. In its response to the DWP's consultation, the PRA stated, "The risks faced by [defined benefit] consolidators are similar to those managed by insurance companies providing annuities. And insurance companies may want to enter the defined benefit consolidation market. There may be unintended consequences if the two types of business are regulated differently." Industry commentators speculate that the future rules will be outlined in the forthcoming Pensions Schemes Bill 2019-20, but the government has not confirmed that this will be the case.



## IV. Global Regulatory and Litigation Developments

In 2019, regulators around the world continued to navigate transformational changes in the insurance industry across innovation and technology, risk transfer, data privacy, reinsurance and many other areas. Regulators also continued to react to the changing global social and economic landscape with respect to, among other areas, best interest standards, cybersecurity and the use of big data, the legalized cannabis business and Brexit. Beginning in early in 2020, the NAIC and U.S. state insurance regulators began taking action to respond to the unique insurance-related challenges that the COVID-19 pandemic presents to insurance industry stakeholders.

### A. U.S. NAIC AND STATE ACTIVITY

#### 1. NAIC Amendments to Credit for Reinsurance Model Law and Regulation to Implement 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 U.S. Department of the Treasury (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 December 2018, in anticipation of the UK’s exit from the EU, the U.S. Department of the Treasury (the “**Treasury**”) and the Office of the U.S. Trade Representative announced their intent to enter into a “Bilateral Agreement between the U.S. and the United Kingdom 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 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.

A primary focus of the Covered Agreements are the changes with respect to reinsurance collateral requirements. Under the Covered Agreements, a U.S. territory (i.e., state) is prohibited from imposing any reinsurance collateral requirements upon a qualifying 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 changes with respect to reinsurance collateral requirements do not apply to reinsurance agreements that were entered into before the effectiveness of the Covered Agreements, or to losses that were incurred or to reserves that were posted before the Covered Agreements’ effectiveness. Nothing in the Covered Agreements alters the capacity of parties to any reinsurance agreement to renegotiate such reinsurance agreement or to agree on requirements for collateral on a contractual basis in excess of those required by law.

Under each of the Covered Agreements, U.S. regulators have until September 2022 (60 months, or five years from the date the U.S.-EU Covered Agreement was signed) to adopt reinsurance reforms consistent with the Covered Agreements. On June 25, 2019, the NAIC adopted revisions to the Credit for Reinsurance Model Law (#785) and the Credit for Reinsurance Model Regulation (#786) (together, the “**Revised CFR Model Laws**”) to incorporate the collateral reduction requirements. The revisions to the CFR Model Laws permit a ceding insurer to take credit for reinsurance ceded to a qualifying unauthorized reinsurer without collateral if the reinsurer satisfies certain criteria, including being domiciled in a “reciprocal jurisdiction.” Under the Revised CFR Model Laws, a “reciprocal jurisdiction” includes (a) a non-U.S. jurisdiction (such as the EU and the UK) that has entered into a covered agreement with the U.S., (b) a “qualified jurisdiction” that meets certain additional requirements consistent with the terms and conditions of the Covered Agreements and (c) any NAIC-accredited U.S. state. At the NAIC’s 2019 Fall National Meeting (the “**Fall 2019 National Meeting**”), the NAIC approved Bermuda, Japan and Switzerland as “reciprocal jurisdictions.”

In addition, at the Fall 2019 National Meeting, the Financial Regulation Standards and Accreditation (F) Committee adopted the 2019 revisions to the CFR Model Laws as an accreditation standard. It is

*In 2019, regulators around the world continued to navigate transformational changes in the insurance industry...*

*Regulators also continued to react to the changing global social and economic landscape with respect to, among other areas, best interest standards, cybersecurity and the use of big data, the legalized cannabis business and Brexit.*





expected that the NAIC Executive/Plenary will formally adopt the accreditation standards at or before the NAIC's Spring 2020 National Meeting (the "**Spring 2020 National Meeting**") to be effective September 1, 2022.

## 2. Life Insurance and Annuities

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

On February 13, 2020, the Executive and Plenary Committees adopted revisions 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. As amended, the SAT includes a requirement for producers to act in the "best interest" of a retail customer when making a recommendation of an annuity. Under the amended SAT, a producer has acted in the best interest of the customer if he or she has satisfied certain prescribed obligations regarding care, disclosure, conflict of interest and documentation.

Throughout 2019, the Annuity Suitability (A) Working Group ("**ASWG**") worked on the amendments to the SAT and carefully evaluated whether the amendments should impose a "best interest" standard. The amendments to the SAT that were exposed at the end of 2018 did not include a standard that expressly referenced the "best interest" of the consumer. In June 2019, the SEC adopted Regulation Best Interest, which imposes a "best interest" standard on broker-dealers and associated persons in connection with certain investment transactions. See section IV.B.2 below for further discussion regarding the final federal rule. By adopting a similar standard under the amended SAT, the NAIC is seeking to harmonize the state and federal standards that apply to similar transactions.

### b. New York Best Interest Standard

In 2018, the NYDFS adopted amendments to its regulation based on SAT ("**Regulation 187**") to incorporate a "best interest" standard with respect to the suitability of both life insurance and annuity sales. Such amendments took effect on August 1, 2019 with respect to annuity contracts and February 1, 2020 with respect to life insurance policies.

Regulation 187 requires the producer, or insurer if no producer is involved, to act in the best interest of the consumer when recommending the sale of a life insurance policy or annuity. Regulation 187 generally applies to both new sales and transactions involving in-force policies, although the compliance burden is more significant in connection with new sales. In a new sale, the producer or insurer acts in the consumer's best interest when it collects from the consumer sufficient information to evaluate the consumer's needs and ultimately determines that the recommended product is "suitable" for the consumer based on this review. In contrast, to satisfy the "best interest" standard for an in-force transaction, the producer or insurer need not consider suitability information in making a recommendation. Further, Regulation 187 sets forth insurer supervisory requirements for new sales, but such requirements do not expressly apply to in-force transactions. Regulation 187 also requires that insurers train producers to ensure compliance with its provisions, both for in-force transactions and new sales. The effect of Regulation 187 on a particular transaction also varies based on the product and the distribution channel involved.

The amendments to Regulation 187 have met various forms of resistance in the market. In the early stages, several interested parties filed lengthy comment letters outlining their objections while other groups filed lawsuits to stop implementation of the amendments. Three significant life and annuity writers announced they were suspending the sale of certain insurance products in New York. Although these insurers were not always explicit in their rationale, many analysts concluded that these companies were withdrawing from the New York market due to Regulation 187. In the wake of these announcements, the NYDFS released clarifying guidance regarding the amendments to Regulation 187 in which the NYDFS reassured insurers and producers that it would not take an aggressive stance on enforcement during the early phases of implementation. Following the issuance of that guidance, two of these companies have reversed their decisions to suspend certain sales in New York. Another has not publicly disclosed any change in its plans.

### c. NAIC Evaluates Age Restrictions on Indices Used in Annuity Illustrations

For over two years, the Annuity Disclosure (A) Working Group (“**ADWG**”) has been working on revisions to the Annuity Disclosure Model Regulation (#245) (“**Model 245**”). The revisions to Model 245 were originally sought by industry in order to allow for the use of indexes that have been in existence for less than 10 years in fixed index annuity illustrations; such indexes are currently prohibited to be used in illustrations in states that have adopted the relevant portion of the current version of Model 245. In response to the request by industry to decrease the number of years in which a fixed index annuity must be in existence for illustration purposes, members of the ADWG have instead proposed lengthening the required periods that indexes must be in existence prior to including them in illustrations. After several exposed drafts of revisions to Model 245, members of the ADWG have agreed to the following revisions of Model 245:

- Requiring index history of 15 years for illustration purposes (unless 20 years of history is otherwise available for illustration);
- Requiring “backcast” history be visually delineated from “actual” history; and
- Requiring any constructed indexes that use algorithms to have such algorithms be fixed from the creation of the index.

Several issues remain under discussion at the ADWG, including:

- The inspection rights with respect to the index’s components for either the commissioner and/or consumer; and
- The definition of “financial instruments” in connection with constructed indexes being allowed to include “financial instruments” that have been existence for at least 15 years.

Any proposed changes to Model 245 must advance through the NAIC review process before being adopted and, therefore, any of the above-referenced changes may be amended during the course of this process.

### d. New York Issues Circular Letter Regarding Pension Risk Transfer Business and Soliciting, Negotiating, Selling and Servicing Group Annuity Contracts Issued by Unauthorized Insurers

In connection with its recent examination of the pension risk transfer industry in New York, the NYDFS issued Circular Letter No. 10 (2019) (the “**Circular Letter**”) to remind life insurers and insurance producers that unauthorized insurers and their employees and other representatives are prohibited from transacting the business of insurance from an office or any other location in New York.

Generally, a pension risk transfer transaction involves a defined benefit pension plan transferring some or all of a benefit plan’s obligations to a third party. Although a pension risk transfer transaction can take a variety of forms, a common structure is where an insurance company takes the responsibility for paying the plan’s guaranteed benefits through the issuance of a group annuity contract to the plan sponsor and certificates of coverage thereunder to the plan’s individual participants.

The Circular Letter explains that only New York authorized insurers may solicit, negotiate, sell and service group annuity contracts, whether through in-person meetings, telephone calls, mail, emails or access to web portals, with respect to certificate-holders that are New York residents.

The Circular Letter, summarizing the current state of the law, notes that unauthorized insurers may conduct certain limited activities in New York that constitute “back office” functions. These back office functions “are extremely limited in scope” and include “gathering information about the insurance industry; assembling policies on non-New York risks; and mailing completed applications on non-New York risks to the placing agent out of state.”

The Circular Letter states that any group annuity contract and certificates issued in connection with a pension risk transfer transaction “should be delivered or issued for delivery in New York by a New York-authorized insurer and administered by that insurer.” The Circular Letter notes that although an unauthorized insurer affiliated with an authorized insurer may issue and administer a group annuity

contract and certificates issued or delivered outside of New York to non-New York residents, this unauthorized insurer may not solicit, negotiate, sell or service the non-New York group annuity contract or certificates from an office or any other location in New York.

### 3. Health Insurance Regulation — ACA Risk Corridor and Cost-Sharing Reduction Litigation

In December 2019, the U.S. Supreme Court (the “**Supreme Court**”) heard oral argument on whether insurers are entitled to more than US\$12 billion in payments allegedly due under the Patient Protection and Affordable Care Act (“**ACA**”) risk corridors program. The appeal followed a 2-1 decision in favor of the U.S. government by the U.S. Court of Appeals for the Federal Circuit (the “**Federal Circuit**”). In its decision, the Federal Circuit determined that although the plain language of the ACA entitled insurers to full risk corridors payments, that obligation had been suspended and/or repealed due to subsequent appropriation riders adopted by Congress.

The risk corridors program was designed to protect insurers from extreme gains and losses during the initial years of the ACA. Under the three-year program in effect from 2014 to 2016, qualified health plans with lower-than-expected claims were required to make payments to the government, while plans with higher-than-expected claims would receive payments from the government. The government initially stated that the risk corridors program was not budget neutral, such that payments out of the program could exceed collections received by the program. After Congress passed an appropriations rider in December 2014 that limited the source of funding for the program, the government concluded that the sole remaining appropriation to fund risk corridors payment were the monies collected under the program. Accordingly, the government stated that it would now administer the program on a budget-neutral basis and limit payments out to collections received. Congress passed similar appropriation riders for the 2015 and 2016 program years. By the program’s conclusion, payment obligations under the risk corridors exceeded collections received by over US\$12.3 billion. Lawsuits followed.

During oral argument, the Supreme Court justices asked challenging questions of both sides. However, many observers felt that the justices appeared more sympathetic to the insurers. As one justice put it, characterizing the government’s position: “You [insurers] pay in, that’s obligatory. We [the government] commit ourselves to paying out. It turns out, if we feel like it. What—what kind of—what kind of a statute is that?” The Supreme Court’s decision is expected by June 2020.

Litigation has also ensued over governmental non-payment in respect of another ACA program, the cost-sharing reduction (“**CSR**”) payments program. The program was designed to make healthcare under the ACA more affordable for lower-income citizens by reducing deductibles, co-pays and other cost-sharing payments normally borne by insureds. Under the program, insurers would pay some or all of the cost-sharing obligations of eligible insureds, and then be reimbursed by the government. 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.

Over a dozen lawsuits, including one class action, ensued in the U.S. Court of Federal Claims. Of the cases that have reached decision, judges have ruled unanimously in favor of insurers on the CSR issue. Four such cases were consolidated for appeal before the Federal Circuit. In January 2020, the Federal Circuit heard oral argument in those cases. Relying in large part on 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, insurers argued that a similar result was required here. Unlike in the risk corridors context, insurers argued that there was no suggestion that this clear statutory obligation was abrogated by a subsequent appropriation rider or other act of Congress. The government disagreed, arguing that no valid appropriation existed such that there was no obligation to make CSR payments in the first place. In addition, the government argued, insurers suffered little to no damages for 2018 and later years, as insurers set higher premium rates assuming that CSR payments would not be made. Those higher premium rates, in turn, would trigger increased tax credit payments to insurers under the ACA, thereby offsetting any losses, the government asserted. The matter is now fully briefed, but the Federal Circuit may delay its decision until after the Supreme Court rules in the risk corridors cases.

## 4. NAIC Activity Relating to International Insurance Activities

### a. Update on IAIS Activities

On November 14, 2019, the International Association of Insurance Supervisors (the “**IAIS**”) adopted a comprehensive set of reforms designed to enable effective cross-border supervision of internationally active insurance groups and contribute to global financial stability. The adopted reforms include (a) the Common Framework for the Supervision of Internationally Active Insurance Groups (“**ComFrame**”), (b) the Insurance Capital Standard (the “**ICS**”) and (c) the holistic framework for the assessment and mitigation of 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**”). Under ComFrame, an IAIG is defined as an insurance group which has (i) premiums written in three or more jurisdictions, with the percentage of gross premiums written outside the home jurisdiction comprising at least 10% of the group’s total gross written premiums, and (ii) based on a rolling three-year average, total assets of at least US\$50 billion, or gross written premiums of at least US\$10 billion. ComFrame includes measures such as group supervision, group capital requirements, uniform standards for insurer corporate governance, enterprise risk management and other control functions and resolution planning.

A key part of ComFrame is the ICS, which is the group capital component of ComFrame. The ICS will be implemented in a two-phase process. The first phase, which began in January 2020 and will last for five years, is referred to as the “monitoring period” during which the ICS will be used for confidential reporting to group-wide supervisors and discussion in supervisory colleges. During the monitoring period, the ICS will not be used as a prescribed capital requirement; however, after the monitoring period, the ICS will be implemented as a group-wide-prescribed capital standard.

The NAIC is developing a group capital calculation tool using an RBC aggregation methodology for all entities within an insurance holding company system, including non-U.S. entities (the “**GCC**”). The goal is to provide U.S. regulators with a method to aggregate the available capital and the minimum capital of each entity in a group in a manner that applies to all groups regardless of their structure. If the IAIS determines by the end of the monitoring period that the GCC provides comparable (i.e., substantially the same) outcomes to the ICS, the GCC will be considered an outcome-equivalent approach for implementation as a prescribed capital requirement in lieu of the ICS. See section IV.A.4.b below for a discussion on the development of the GCC.

With the adoption of ComFrame, U.S. state insurance regulators will begin a gap assessment to identify areas where the U.S. regulatory standards do not meet the standards under ComFrame. The Group Solvency Issues (E) Working Group is expected to lead this effort to assess the implementation of ComFrame.

#### ii. The Holistic Framework

In late 2018, the IAIS published a proposed Holistic Framework, which was created to assess and mitigate systemic risk in the insurance sector for implementation beginning of 2020. The Holistic Framework recognizes that systemic risk can arise both from sector-wide trends with regard to specific activities and exposures, as well as from a concentration of these activities and exposures in individual insurers. The Holistic Framework consists of an enhanced set of supervisory policy measures and powers of intervention, an annual IAIS global monitoring exercise and collective discussion on the outcomes and appropriate supervisory responses.

The key elements of the Holistic Framework are:

- **Supervisory Material.** An enhanced set of supervisory policy measures for macroprudential purposes, designed to increase the overall resilience of the insurance sector and help prevent insurance sector vulnerabilities and exposures from developing into systemic risk. When a potential systemic risk is detected, supervisory powers of intervention will enable a prompt and appropriate response;



- **Global Monitoring Exercise.** An IAIS global monitoring exercise is designed to assess global insurance market trends and developments, and detect the possible build-up of systemic risk in the global insurance sector. This includes, at an individual insurer and sector-wide level, a collective discussion at the IAIS on the assessment of potential systemic risks and appropriate supervisory responses and reporting to the Financial Stability Board (“**FSB**”) on the outcomes of the global monitoring exercise; and
- **Implementation Assessment.** An IAIS assessment of the consistent implementation of enhanced supervisory policy measures and powers of intervention.

The Holistic Framework moves away from the previous binary approach, in which a set of predetermined policy measures applied only to a small group of identified global systemically important insurers (“**G-SIIs**”) and instead promotes a proportionate application of an enhanced set of supervisory policy measures and powers of intervention for macroprudential purposes to a broader portion of the insurance sector through the ICPs and ComFrame. The policy measures include, but are not limited to, (i) ongoing supervisory requirements applied to insurers, targeted at key potential systemic exposures (i.e., liquidity risk, macroeconomic exposure and counterparty exposure), (ii) macroprudential supervision, aimed at identifying vulnerabilities and addressing the build-up of systemic risk at the individual insurer and sector-wide levels and (iii) crisis management and planning, which includes requirements on recovery and resolution planning, as well as the establishment of crisis management groups.

With the adoption of the Holistic Framework, the FSB has temporarily suspended the identification of G-SIIs beginning in 2020. In November 2022, based on the evaluation of the implementation of the Holistic Framework, the FSB will consider whether to permanently discontinue or re-establish an annual identification of G-SIIs.

## b. NAIC Development of Group Capital Calculation

The Group Capital Calculation (E) Working Group (the “**GCC Working Group**”) has made progress toward developing a U.S. GCC as it completed its field test of the GCC template and instructions in 2019. Approximately 30 volunteer insurance groups, representing 15 lead states, participated in the field testing process. At the Fall 2019 National Meeting, the GCC Working Group received a report of initial results from the GCC field test. Industry expressed a preliminary concern that certain GCC elements conflict with state risk-based capital requirements and suggested that the GCC be revised to conform with such requirements. Once data submissions from three additional insurance groups participating in the field test are analyzed, which was expected to be completed in January 2020, a more fulsome report will be prepared to inform any additional concerns with and proposed revisions to the GCC template and instructions.

The Executive (EX) Committee also approved a model law development request from the GCC Working Group to amend the Insurance Holding Company System Regulatory Act and the Insurance Holding Company System Model Regulation (#450). Such amendments are expected to (i) require the filing of the GCC with lead state regulators, (ii) provide for confidential treatment of the GCC and (iii) provide exemptions to the requirement to file the GCC.

## 5. NAIC Updates Regarding Valuation of Securities

### a. Principal-Protected Notes and “Bespoke” Securities

The Valuation of Securities Task Force (the “**VOS Task Force**”) is in the process of considering updates to the Purposes and Procedures Manual of the NAIC Investment Analysis Office (the “**P&P Manual**”) to address the treatment of principal-protected notes (“**PPNs**”). In February 2020, the VOS Task Force exposed for a 30-day comment period new proposed amendments (the “**New PPN Amendments**”).

The New PPN Amendments propose adding a new section to the P&P Manual that would include an updated definition of PPNs with three examples of transactions that meet the definition of PPNs. The examples are included for demonstrative purposes only and do not include all possible PPN transactions. PPNs are defined therein as “a type of security that repackages one or more underlying investments and for which contractually promised payments according to a fixed schedule are satisfied by proceeds from an underlying bond(s), but for which the repackaged security generates potential additional returns as described in the detail criteria for PPNs.” The New PPN Amendments also provide that transactions

meeting the definition of a PPN must be submitted to the SVO for review under the SVO's Subscript S authority. If the SVO determines that there are no "Other Non-Payment Risks" (as defined in the P&P Manual) and the PPN is otherwise eligible for reporting on Schedule D, then it will permit the PPN to benefit from the filing exemption process. If the SVO determines that there are "Other Non-Payments Risks," then it will not permit the PPN to benefit from the filing exemption process.

The New PPN Amendments specifically exclude from the definition of PPNs the following securities: defeased or pre-refunded securities which have separate instructions in the P&P Manual, broadly syndicated securitizations such as collateralized loan obligations ("**CLOs**") and asset-based securities ("**ABS**") (except as described above), and CLO or ABS issuances held for purposes of risk retention as required by a governing law or regulation. Comments on the New PPN Amendments will be reviewed at the Spring 2020 National Meeting, at which time the VOS Task Force will consider whether additional exposures are necessary.

At the Fall 2019 National Meeting, the VOS Task Force adopted a proposed amendment to the P&P Manual to update the definition and instructions for structured notes that is intended to bring the P&P Manual in line with updates adopted by the Statutory Accounting Principles (E) Working Group ("**SAP Working Group**") to Statement of Statutory Accounting Principles ("**SSAP**") No. 26R — Bonds and SSAP No. 43R — Loan-Backed and Structured Securities as described in greater detail under section IV.A.6.a below.

#### **b. Expansion of Fixed-Income Treatment to Certain Qualifying Funds**

At the Spring 2019 National Meeting, the VOS Task Force adopted an amendment to the P&P Manual to extend fixed-income treatment to certain qualifying funds, which was reflected in the 2019 P&P Manual. The amendment expands the existing framework so that certain investment companies organized as closed-end management companies and unit investment trusts regulated by the SEC can be submitted for analysis by the SVO to determine whether the fund can be characterized as a "fixed-income-like" asset eligible to receive an NAIC designation.

Pursuant to the amendment, the following remain unchanged: (a) investments in SVO-verified money market funds would continue to be reported as cash equivalents under SSAP No. 2R — Cash, Cash Equivalents, Drafts and Short-Term Investments, without a designation, (b) investments in SVO-identified bond exchange-traded funds ("**ETFs**") would still be reported as bonds under SSAP No. 26R — Bonds, with an SVO-assigned NAIC designation and (c) investments in ETFs that are not SVO-listed would continue to be reported as common stock under SSAP No. 30R — Unaffiliated Common Stock, without an NAIC designation.

### **6. NAIC Considers Revisions to Statements of Statutory Accounting Principles**

#### **a. Identification of Related Parties and Affiliates**

At the Fall 2019 National Meeting, the SAP Working Group adopted revisions to SSAP No. 25 — Affiliates and Other Related Parties ("**SSAP No. 25**") to clarify that a transaction that involves an affiliate, or risks of an affiliate, is required to be reported as a related-party transaction or an investment in an affiliate for purposes of statutory accounting, even if the transaction also involves a non-related intermediary. In addition, revisions were made to SSAP No. 26R — Bonds, SSAP No. 32 — Preferred Stock, SSAP No. 43R — Loan-Backed and Structured Securities and SSAP No. 48 — Joint Ventures, Partnerships and Limited Liability Companies to identify that investment transactions are subject to the principles of related parties identified in SSAP No. 25.

The proposed revisions are intended to prevent situations in which affiliated debt is knowingly captured and repackaged to be recorded as "non-affiliated" because of the involvement of a non-related party. In the revisions to SSAP No. 32, NAIC staff included an explanatory footnote, which states that "[a]s identified in SSAP No. 25, it is erroneous to conclude that the inclusion of a non-related intermediary, or the presence of non-related assets in a structure predominantly comprised of related party investments, eliminates the requirement to identify and assess the investment transaction as a related party/affiliated arrangement." A separate footnote to the revisions to SSAP No. 43R states that "[w]ith the identification of whether the reporting entity has a minor ownership interest, reporting entities must also identify whether the investment is an affiliate transaction. Pursuant to the concepts reflected in SSAP No. 25, consideration shall be given to the substance of the transaction, and the parties whose

action or performance materially impacts the insurance reporting entity holding the security.” While these footnotes are intended to clarify that the test for determining what makes an investment related or nonrelated is one of facts and circumstances, it remains to be seen how regulators will interpret whether an investment is “predominately” comprised of related-party investments or whether a reporting entity has a “minor ownership interest,” leaving uncertainty regarding how these revisions will be applied.

At the Fall 2019 National Meeting, the SAP Working Group also exposed for comment additional revisions to SSAP No. 25 to clarify and incorporate new disclosures regarding the identification of related parties and affiliates largely aimed at aligning related party and affiliate reporting under Statutory Accounting Principles (“**SAP**”) with SEC reporting requirements, the latter of which focus on beneficial ownership and do not include the concept of a disclaimer of control or affiliation (a “**Disclaimer**”). Of particular note, the proposed revisions would subject to SSAP No. 25 requirements and reporting any material transaction between an insurer and a counterparty that is greater than 10% owned by either the insurer or a related party or affiliate of the insurer, even if a Disclaimer has been allowed with respect to such counterparty. Concerning the effect of a Disclaimer under SAP, although a Disclaimer affects holding company group allocation and reporting as a Subsidiary, Controlled and Affiliated Entity under SSAP No. 97 — Investments in Subsidiary, Controlled and Affiliated Entities, a Disclaimer does not eliminate either the classification of an entity subject to a Disclaimer as a related party or the disclosure of material transactions with such entity as required under SSAP No. 25. The deadline to submit comments to the exposed revisions is January 31, 2020, and it is expected that the SAP Working Group will work to adopt these revisions by the end of 2020.

#### b. Levelized and Persistency Commission Arrangements

The SAP Working Group is considering revisions to SSAP No. 71 — Policy Acquisition Costs and Commissions regarding levelized and persistency commission arrangements. The proposed revisions would clarify that (i) a levelized commission arrangement (whether linked to traditional or nontraditional elements) requires the establishment of a liability for the full amount of the unpaid principal and accrued interest payable to a third party, such as a funding agent, at the time the policy is issued and (ii) persistency commission must be accrued proportionately over the policy period in which the commission relates and cannot be deferred until fully earned.

In response to industry concerns that the proposed revisions could be interpreted to require that a traditional persistency commission be accrued for multiple years, NAIC staff noted that this was not the intent and modified the proposed guidance accordingly. NAIC staff reiterated that the intent of the proposed guidance is to require accrual of levelized commission arrangements that are termed “persistency,” not to change the annual accrual of traditional persistency commissions.

Industry also observed that the newly implemented PBR methodology includes consideration of commissions when projecting future cash flows and expressed concern that the effects of the proposed revisions have not been analyzed to determine whether there are any unintended consequences, such as double counting. Following preliminary discussions with the Life Actuarial (A) Task Force (the “**LATF**”), double counting was not anticipated to be an issue as projected future cash flows would not double count if there is an existing liability. The SAP Working Group referred the issue to the LATF for further consideration, including whether revisions are required to relevant provisions of the NAIC Valuation Manual.

The SAP Working Group will further consider the proposed revisions and related stakeholder comments, which were due January 31, 2020, at the Spring 2020 National Meeting.

#### c. Treatment of Collateralized Fund Obligations

At the NAIC’s Summer 2019 National Meeting, (“**Summer 2019 National Meeting**”) the SAP Working Group voted to expose for comment revisions to SSAP No. 43R — Loan-Backed and Structured Securities (“**SSAP No. 43R**”) to clarify that collateralized fund obligations (“**CFOs**”) and similar structures that reflect underlying equity interests but are issued in the form of debt instruments are not within the scope of SSAP No. 43R. The issue of the application of SSAP No. 43R to CFOs and related instruments was brought to the attention of NAIC staff by an unidentified rating provider who contacted the NAIC to request information regarding the treatment of CFOs for statutory accounting purposes. After reviewing the matter, NAIC staff proposed revisions to SSAP No. 43R to clarify that the intent of SSAP No. 43R is

to capture investments that have bond-like cash flows and to explicitly exclude (a) any structures with underlying equity exposures and (b) securitization of assets that were previously reported as standalone assets by the insurer (i.e., existing assets that are “repackaged” via securitization). These changes were initially categorized as “nonsubstantive” for purposes of review by the SAP Working Group and exposed for a 90-day comment period.

In January 2020, the SAP Working Group met by conference call specifically to discuss comments received from industry on the exposed revisions. While industry acknowledged that they are supportive of eliminating potential abuses, they found the proposed revisions to SSAP No. 43R were too broad and went beyond addressing the concerns it noted as being at issue, thus potentially resulting in the elimination of billions of dollars of assets that the industry believes are appropriately accounted for under SSAP No. 43R. Industry recommended that any further proposed changes should take into account their potential immediate effects on current markets, noting that the proposed revisions effectively froze the market on CFOs following exposure at the Summer 2019 National Meeting.

In response to these comments, NAIC staff issued recommendations to the SAP Working Group to reclassify the project as “substantive” and to direct NAIC staff to develop an issue paper that will document the rationale for all investments covered by the proposed revisions to SSAP No. 43R. The SAP Working Group directed NAIC staff to proceed with preparing the issue paper, and NAIC staff expects to provide a draft of the issue paper for discussion at the Spring 2020 National Meeting. Both members of the SAP Working Group and the industry agreed that the process for preparing the issue paper should not be driven by timing concerns and that a full review of the scope of investments that will be in and out of scope of SSAP No. 43R should be completed.

#### **d. Surplus Notes**

The SAP Working Group continues to consider whether “linked surplus notes” will be subject to different statutory accounting treatment and enhanced statutory financial statement disclosures under SSAP No. 41R — Surplus Notes (“**SSAP No. 41R**”). Transactions involving linked surplus notes include multi-layered transactions in which cash flows from surplus notes and other instruments are linked. Such transactions “include situations in which terms negate or reduce cash flow exchanges, and/or when amounts payable under surplus notes and amounts receivable under other agreements or assets can be 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 agreement, asset or surplus note.”

The proposed revisions to SSAP No. 41R would incorporate guidance providing that linked surplus notes do not qualify for surplus note accounting treatment (which provides for the reporting of surplus notes as equity under SAP) and should therefore be treated as debt under SSAP No. 15 — Debt and Holding Company Obligations. In response to stakeholder comments to the proposed revisions, including those discussing potential unintended consequences that such revisions could have on existing transactions, the SAP Working Group determined it required additional information to further analyze the issue and directed NAIC staff to conduct a data call. The data call requested information by December 31, 2019, regarding insurance reporting entities that file statutory financial statements with the NAIC, have linked surplus notes and would be affected by the proposed revisions to SSAP No. 41R.

Additional revisions to SSAP No. 41R were exposed on December 7, 2019, to provide enhanced financial statement disclosures in order to identify surplus notes issued with anticipated or typical cash flows that have been partially or fully offset through the terms of an asset provided by the surplus note holder. The SAP Working Group noted that improved disclosures with respect to linked surplus notes would reduce the need for subsequent data calls to collect information regarding such notes.

The SAP Working Group will further consider the proposed revisions, information received via the data call and stakeholder comments to the enhanced financial statement disclosures, which were due January 31, 2020, at the Spring 2020 National Meeting.



## 7. States Continue Efforts to Address Innovation and Technology in the Insurance Sector

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

In October 2017, the NAIC adopted the Insurance Data Security Model Law (#668) (the “**IDS Model Law**”), which provides, among other things, that state insurance licensees must maintain a comprehensive written Information Security Program (the “**Program**”). The Program must be commensurate with the size and complexity of the licensee, the nature and scope of the licensee’s activities, including its use of third-party service providers, and the sensitivity of the non-public information used by or possessed by the licensee. The Program must also be based on a risk assessment and contain administrative, technical, and physical safeguards for the protection of non-public information and the licensee’s information systems. In addition to maintaining the Program, under the IDS Model Law, licensees must (i) investigate and timely report data breaches, (ii) exercise due diligence in selecting third-party service providers, (iii) conduct risk assessments, and (iv) annually certify compliance with security provisions to the state insurance commissioner.

The IDS Model Law was influenced significantly by the cybersecurity regulation that the NYDFS promulgated during the time that the NAIC was developing the IDS Model Law. As a result, the IDS Model Law is similar to the NYDFS cybersecurity regulation in structure and substance.

In May 2018, South Carolina was the first state to adopt a version of the IDS Model Law. The South Carolina Insurance Data Security Act (the “**South Carolina Act**”), which is modeled after the IDS Model Law, became effective January 1, 2019, and by July 1, 2019 licensees were required to have established 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 adopted a version of the IDS Model Law under which licensees have until January 20, 2022 to implement the provisions of their respective written information security programs.

During 2019, an additional six states adopted a version of the IDS Model Law: Alabama, Connecticut, Delaware, Mississippi, New Hampshire and Ohio. The legislatures of Indiana, Maine and Virginia are currently considering bills that are based on the IDS Model Law as well.

While the eight states’ respective versions of the IDS Model Law contain the same essential structure and requirements as set forth in the IDS Model Law, there are divergences among these laws. For example, the breach notification deadline in the IDS Model Law is 72 hours; however, under Michigan’s law, the deadline is 10 days and certain other states have clarified that the 72-hour requirement actually means three full business days.

The state laws also lack uniformity with respect to exemptions for certain smaller licensees. Under the IDS Model Law, licensees with fewer than 10 employees and independent contractors are exempt from the law’s information security program requirement. Ohio’s law, by contrast, exempts licensees that have fewer than 20 employees or (i) less than US\$5 million in gross annual revenue; or less than US\$10 million in assets, measured at the end of the licensee’s fiscal year. The exemption under Mississippi’s law includes the same dollar thresholds as Ohio’s law, but increases the minimum employee threshold to 50 employees and expressly excludes independent contractors.

### b. NAIC Activity Related to Anti-Rebating Laws

The Innovation and Technology (EX) Task Force (“**IT Task Force**”) initiated a model law amendment process to revise the NAIC’s Model Unfair Trade Practices Act (#880) to address concerns raised by interested parties that perceive the existing anti-rebating laws to be an obstacle to innovative insurance solutions. Under the NAIC Unfair Trade Practices Act and existing state rebating laws, insurers are prohibited from offering value-added products, services or programs in conjunction with the sale of an insurance policy as an inducement to purchase insurance. The amendments will focus on Section 4H to clarify what is considered a “rebate” or “inducement” as regulators acknowledge that certain value-added products, services and programs that are intended to protect policyholders or otherwise mitigate the risk of loss to a person or property should not be prohibited.

### c. NAIC Continues to Consider the Use of Big Data and Blockchain Technology in the Insurance Industry

Over the last year, the NAIC has continued to consider the use of (a) big data for predictive modeling in rate filings by P&C insurers and (b) blockchain technology in the insurance industry. Additionally, the NAIC has expanded the scope of its examination of big data usage by reviewing such use in connection with accelerated underwriting for life insurance and insurer claims practices.

With respect to life insurance, the Big Data (EX) Working Group (“**BDWG**”) adopted a motion requesting that the Life Insurance and Annuities (A) Committee study the use of big data in accelerated life underwriting and draft best practices guidance for regulators. Accelerated life underwriting involves replacing medical exams and the collection of bodily fluids with information from data models similar to aspects of credit-based scoring. See section IV.A.7.e below for more information regarding the Accelerated Life Underwriting Working Group. The Life Actuarial (A) Task Force is evaluating the actuarial soundness of those methods for predicting mortality.

Another area of regulatory concern that the BDWG agreed to consider is the use of big data in insurer claim practices. This includes both antifraud efforts and claims valuation, such as whether insurers are using models for claims optimization. Those models evaluate the potential of settling a claim at a set amount based on the characteristics of the claimant.

In addition, the NAIC Center for Insurance Policy and Research (the “**CIPR**”) hosted a panel of industry representatives to discuss the use of blockchain technology in the insurance industry. Blockchain is a ledger technology that creates a shared system of record through advanced encryption methods. Advocates of blockchain note that it has the potential to improve the efficiency, security and trustworthiness of a wide variety of transactions. Insurance companies, industry members and certain regulators are testing a variety of programs that use blockchain technology to explore its application in the insurance industry. For example, the American Association of Insurance Services has developed openIDL, a blockchain platform that streamlines regulatory reporting by allowing insurers and regulators to upload and share data to a secure blockchain platform, intended to lessen the time and costs associated with handling regulatory and compliance requirements for both insurers and regulators.

The sole regulator on the CIPR panel was Commissioner Michael Pieciak of the Vermont Department of Financial Regulation (the “**VDFR**”) who spoke about the VDFR’s January 15, 2019 study of the potential applications of blockchain technology within the banking and insurance industries. The VDFR has been active in exploring the uses of blockchain technology and has announced a joint commitment with the Vermont Secretary of State to launch a pilot program to test the use of blockchain in state regulatory processes. The pilot program will test the use of blockchain technology in the registration process for new Vermont captive insurance companies. While the potential uses of blockchain are still being explored, many in the industry are optimistic that blockchain will continue to develop and have an impact across the insurance industry.

### d. Best Practices for Regulatory Review of Predictive Analytics White Paper

The NAIC’s Casualty Actuarial and Statistical (C) Task Force has exposed a draft white paper regarding regulatory review of predictive models within insurer rate filings. The white paper identifies “best practices” currently used in a number of states and provides guidance for regulators implementing those best practices. In response to the exposed draft, industry submitted 10 comment letters, and state insurance regulators submitted eight. While the comment letters remain subject to further review, one of the main concerns expressed is whether the identified best practices are too burdensome for application in all states. In addition, several common “policy-level” concerns have been raised, including how to maintain the confidentiality of data collected and the degree of transparency to a consumer regarding the data used in a model, its impact on premium and a consumer’s right to correct such data.

### e. Accelerated Underwriting Working Group

The Accelerated Underwriting Working Group (the “**AUWG**”) was recently formed based on a referral from the Big Data (EX) Working Group, and is charged with considering the use of external data and data analytics in accelerated life underwriting (i.e., underwriting life products without the use of traditional medical examinations or blood and urine tests), including consideration of the ongoing work of the Life Actuarial (A) Task Force on the issue and, if appropriate, drafting guidance for the states. The AUWG

held its first conference call on October 2, 2019, during which it discussed a draft work plan. Initial efforts of the AUWG are focused on information gathering through various presentations to better understand accelerated underwriting in life insurance. The AUWG anticipates reaching a decision on the type of work product it will prepare by the NAIC's Summer 2020 National Meeting and finalizing such work product prior to or at the NAIC's Fall 2020 National Meeting.

#### **f. New York Department of Financial Services Issues Guidance Regarding Life Insurers' Use of External Consumer Data in Underwriting**

On January 18, 2019, the NYDFS issued Circular Letter 2019-1 ("**Circular Letter 2019-1**"), addressing insurers' use of external consumer data and information sources in underwriting for life insurance. Circular Letter 2019-1 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, Circular Letter 2019-1 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.

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. Circular Letter 2019-1 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. Circular Letter 2019-1 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. Circular Letter 2019-1 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. Circular Letter 2019-1 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.

Circular Letter 2019-1 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. Circular Letter 2019-1 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.

#### g. AI Working Group

At the Summer 2019 National Meeting, the IT Task Force adopted a motion to form the Artificial Intelligence (EX) Working Group (the "**AI Working Group**"). The AI Working Group is charged with studying the development of artificial intelligence, its use in the insurance sector and its effect on consumer protection and privacy, marketplace dynamics and the state-based insurance regulatory framework. The AI Working Group will develop regulatory guidance, beginning with guiding principles, and make other recommendations to the IT Task Force, as appropriate, by the NAIC's Summer 2020 National Meeting. The AI Working Group exposed a draft of guiding principles (the "**AI Draft Guiding Principles**") prepared by the North Dakota Insurance Department for a comment period, which ended on January 17, 2020. The AI Draft Guiding Principles set out high-level principles related to fairness, ethics, accountability, compliance, transparency, security and risk management that insurance companies and other persons facilitating the business of insurance should follow when playing an active role in the artificial intelligence system lifecycle.

### 8. Privacy

#### a. California Consumer Privacy Act

The first data protection and privacy law of its kind, the California Consumer Privacy Act (the "**CCPA**"), went into effect on January 1, 2020. The CCPA applies to "businesses" (i.e., certain for-profit entities doing business in California) and grants "consumer" rights to, among other things, access, delete or stop the sale to third parties of their "personal information." The CCPA includes broad privacy policy disclosure requirements and provides for a private cause of action for data breaches with damages permitted without proof of harm (although companies are given a chance to cure violations). Under the CCPA, the California Attorney General is authorized to enforce with statutory fines of up to US\$7,500 per violation, with enforcement by the California Attorney General likely to start by mid-2020.

Importantly, the CCPA includes an exemption for certain federally regulated entities, including a broad exemption for "personal information collected, processed, sold, or disclosed pursuant to the federal Gramm-Leach-Bliley Act (Public Law 106-102) (the "**GLBA**"), and implementing regulation." Notably, this exception does not apply to the private cause of action for data breaches, meaning, if a business has a data breach that involves GLBA-covered personal information, consumers have a private right of action under the CCPA to sue for redress of harm. The exception also may not apply to certain data that does not qualify as non-public information under the GLBA, for instance, prospective client data or prospective employee/recruiting data.

Further guidance regarding the CCPA is forthcoming from the California Attorney General. In October 2019, the California Attorney General published proposed regulations. On February 7, 2020, the California Attorney General published a second version of proposed regulations, and on February 10, 2020 the California Attorney General again updated the proposed regulations. Public comments to the proposed regulations were due by February 25, 2020.

In addition to California, other states continue to consider whether to adopt new and broader privacy laws, with Nevada taking the distinction of being the first to follow the CCPA trend. The scope and



obligations of the Nevada law are significantly narrower than the CCPA, focusing on websites or online service operators (rather than businesses), providing only a limited number of obligations and data subject rights, and more narrowly defining covered personal information.

Many other states are at various stages of drafting and passing similar laws including, Arizona, Florida, Kentucky, Maine, Massachusetts, Minnesota, Mississippi, Montana, Pennsylvania, New Jersey, New York and Washington.

#### **b. NAIC Privacy Protections Working Group**

Privacy of consumer information has become an area of regulatory focus as recent technological innovations in the insurance industry have increased the collection and use of information gathered in connection with insurance transactions. In the wake of the adoption of the General Data Protection Regulation and the CCPA (see section IV.A.8.a above), the newly formed Privacy Protections Working Group is charged with reviewing state insurance privacy protections and making recommended changes, as needed, to existing NAIC model laws. Such review expressly excludes a review of data security, which deals with how information that a business has already collected and has in its possession is protected from unauthorized access. See section IV.A.7.a above for a discussion of state adoption of the NAIC's recently adopted data security model law.

Throughout 2020, the working group will consider the industry requirements and consumer rights appropriate for the collection, use and disclosure of information gathered in connection with insurance transactions and draft and adopt amendments, if needed, to existing NAIC privacy models, such as the NAIC Insurance Information and Privacy Protection Model Act (#670) and the Privacy of Consumer Financial and Health Information Regulation (#672). The working group plans to present adopted amendments, if any, to the Market Regulation and Consumer Affairs (D) Committee at the NAIC's Summer 2020 National Meeting.

### **9. NAIC Activity Related to Long-Term Care Insurance**

Recognizing the importance of bringing stability to the long-term care insurance market, the NAIC membership formed the Long-Term Care Insurance (EX) Task Force ("**LTC Task Force**"), which reports to the Executive (EX) Committee. Virginia Insurance Commissioner Scott A. White and Colorado Insurance Commissioner Michael Conway serve as Chair and Vice Chair, respectively, of the LTC Task Force. An additional 42 states are represented on the LTC Task Force.

The LTC Task Force has organized the following six work streams (each led by the state identified in parentheses) that are relevant to its charge to develop a consistent national approach for reviewing long-term care insurance rates that result in actuarially appropriate increases being granted by the states in a timely manner and eliminates cross-state rate subsidization: (a) multistate rate review practices (Colorado); (b) restructuring techniques (Texas); (c) reduced benefit options and consumer notices (Pennsylvania); (d) valuation of long-term care insurance reserves (Minnesota); (e) nonactuarial variance among the states with respect to rate decisions (Washington); and (f) data call design and oversight (Virginia). The LTC Task Force expects to conduct certain work streams publicly, while others will be transacted in closed session due to anticipated discussions regarding specific companies.

The LTC Task Force is charged with delivering a report on these issues to the Executive (EX) Committee by the NAIC's Fall 2020 National Meeting. Unless otherwise affirmatively extended or modified by the Executive (EX) Committee, the LTC Task Force and its charges will expire on January 31, 2021.

### **10. NAIC Adopts White Paper on Understanding the Market for the Legalized Cannabis Business**

On July 9, 2019, the Cannabis Insurance (C) Working Group adopted a white paper entitled *Understanding the Market for Cannabis Insurance*.

The white paper details the insurance regulatory issues presented by the burgeoning cannabis industry. As the white paper explains, the cannabis industry continues to be one of growth — many states continue to carve out exceptions for cannabis use, with 33 states and Washington, D.C. allowing medical cannabis use and 11 states and Washington, D.C. allowing recreational cannabis use. Hemp use is legal in all 50 states pursuant to the 2018 federal farm bill.

The white paper identifies key areas of concern for insurers. States have started requiring insurance for cannabis businesses with some, such as California and Massachusetts, requiring insurance for licensure. Nonetheless, cannabis remains a Schedule I drug under the Controlled Substances Act, triggering potential legal issues with many federal statutes (e.g., the Banking Secrecy Act). The interplay of these statutes and state law is still unclear. Last year, U.S. Attorney General William Barr stated that he would not target legal cannabis businesses operating intrastate.

The white paper also explains the process of the cannabis business supply chain, highlighting the need for several different types of insurance which includes, but is not limited to, general liability, workers' compensation, product liability and property insurance. The white paper cites certain other types of insurance, but more types remain to be determined; due to the relatively new nature of these businesses, and the rate at which some factors shift, the adequacy of insurance coverage is apt to change quickly. The white paper recommends that state regulators continue to educate insurance companies and monitor any insurance coverage gaps in order to sufficiently fill these gaps, ideally leading to a well-covered and regulated cannabis insurance industry.

### 11. NAIC Prepares Best Practices Guidance Related to Final Federal Flood Insurance Rule

On November 19, 2019, the Catastrophe Insurance (C) Working Group (the "**CIWG**") adopted a document to guide regulators on the development of the private flood insurance market. The CIWG produced the document, entitled *Considerations for State Insurance Regulators in Building the Private Flood Insurance Market* (the "**Private Flood Insurance Guidance**"), in response to recent changes in federal law.

By way of background, the Biggert-Waters Flood Insurance Reform Act of 2012 ("**Biggert-Waters**"), a law passed by Congress and signed by President Obama, not only extended the National Flood Insurance Program ("**NFIP**") for five years but also included certain reforms intending to encourage the development of the private flood insurance market.

Prior to the passage of Biggert-Waters, regulated lenders were prohibited from making loans secured by real properties with improvements located within qualifying special flood hazard areas in communities that participate in the NFIP unless the property had sufficient flood insurance coverage for the full loan term. Biggert-Waters, in contrast, requires lenders to accept private flood insurance policies, meeting certain requirements, to satisfy the mandatory purchase requirement described above.

On July 1, 2019, the final rule issued by federal banking regulators implementing Biggert-Waters took effect, a significant development for the private flood insurance market. The final rule requires insurers to certify that their private flood insurance policies meet the necessary requirements set forth in Biggert-Waters in order for lenders to be required to accept such policies. The rule also allows lenders to accept private flood insurance policies that do not meet the mandatory acceptance requirements set forth in Biggert-Waters, subject to certain conditions.

The Private Flood Insurance Guidance includes details about how certain states have enacted procedures to enhance the private flood insurance markets in their respective states. These procedures include: (i) supporting private flood insurance legislation and initiatives; (ii) approving private flood insurance products; (iii) tailoring rate and form requirements for residential private flood insurance products; (iv) including flood insurance on the state's export lists in order to make it easier to place these policies on a surplus lines basis; and (v) consumer, agent and lender education.

### 12. NAIC Discusses Mechanisms for Voluntary Restructuring of Solvent Insurers

The Restructuring Mechanisms (E) Working Group (the "**Restructuring Working Group**") was formed in early 2019 and charged with preparing a white paper that, among other things, addresses the need for, and issues related to, mechanisms for voluntary restructuring of solvent insurers, including insurance business transfers ("**IBTs**") and corporate divisions ("**ICDs**"). IBTs effect a statutory novation of a policy, whereas ICDs effect a division of an insurance company by operation of law. For nearly 40 years, IBT transactions have taken place in the UK, where they are known as "Part VII transfers." In the U.S., Oklahoma, Rhode Island and Vermont are among the states that have adopted laws authorizing IBTs. In November 2019, Oklahoma became the first insurance department in the U.S. to approve an IBT

transaction. This transaction involved the transfer of the Rhode Island-based Providence Washington Insurance Company ("**Providence Washington**") to the Oklahoma-based Yosemite Insurance Company, pursuant to which the majority of Providence Washington's book of business will be underwritten or assumed by Yosemite Insurance Company. Arizona, Connecticut, Georgia, Illinois, Iowa, Michigan, Nebraska and Pennsylvania are among the states that have adopted laws authorizing ICDs.

While the Restructuring Working Group is still in the early stages of preparing the white paper, it has heard various presentations and received comment letters from interested parties on such voluntary restructuring mechanisms. Some life insurance companies have urged "extreme caution" in the consideration of laws that permit insurers to divide or transfer life, annuity or long-term care contracts. Other insurance companies have expressed support for the development of effective IBT and ICD models. According to these insurers, an orderly IBT and ICD process supervised by effective regulators applying procedural safeguards will enable firms to operate more efficiently, better manage their capital and improve solvency by encouraging and facilitating the flow of new capital to the industry, which will ultimately benefit consumers.

In connection with preparing the white paper, the Restructuring Working Group is expected to consider the standards of review that should apply to IBTs and ICDs, the expected level of reserves and capital after the restructuring transaction (including the adequacy of long-term liquidity needs), the impact that a restructuring might have on guaranty associations and policyholders that had guaranty association protection prior to the restructuring, and the process for monitoring companies after the transaction is completed. The target date for the completion of the white paper is summer 2020.

### 13. NAIC and State Insurance Departments Respond to COVID-19 Pandemic

Beginning in early 2020, the NAIC and U.S. state insurance regulators began taking action to respond to the unique insurance-related challenges that the COVID-19 pandemic presents to insurance industry stakeholders. Specifically, the NAIC and state insurance departments have issued guidance in response to COVID-19 covering topics such as health insurance operations and coverage, travel insurance coverage, business interruption insurance coverage, and operational issues for regulators, insurers and other regulated entities. Guidance from the NAIC and state insurance departments related to COVID-19 is developing rapidly and is subject to change as this crisis continues.

#### a. Regulatory Guidance Related to Health Insurance Operations and Coverage

As a public health crisis, the COVID-19 pandemic has particularly affected the health insurance industry. As of March 22, 2020, the NAIC and 44 U.S. state insurance departments have issued guidance to health insurance carriers in the areas of telehealth, consumer outreach, special enrollment periods, prescription refills and cost-shares (co-pays, deductibles and co-insurance). The applicable states include: Alabama, Alaska, Arizona, California, Colorado, Connecticut, Delaware, Florida, Georgia, Illinois, Iowa, Kansas, Kentucky, Louisiana, Maine, Maryland, Massachusetts, Michigan, Minnesota, Mississippi, Missouri, Montana, Nebraska, Nevada, New Hampshire, New Jersey, New Mexico, New York, North Carolina, North Dakota, Ohio, Oklahoma, Oregon, Pennsylvania, Rhode Island, South Carolina, Tennessee, Texas, Utah, Vermont, Washington, West Virginia, Wisconsin and Wyoming.

Specifically, in this guidance, many of these states are:

- Requiring insurers to waive cost-sharing for COVID-19 testing when ordered in accordance with Centers for Disease Control and Prevention (CDC) guidelines, and prohibiting insurers from requiring prior authorization for such testing;
- Requiring insurers to permit early refills, except for drugs in certain drug classes such as opioids, when consistent with doctor/pharmacist approvals;
- Directing insurers to keep their policyholders informed with accurate information about coverage for COVID-19-related testing and treatment;
- Directing insurers to expand the availability of telemedicine for their policyholders and eliminating barriers to its use; and
- Directing insurers to continue to ensure network adequacy given the anticipated increase in demand due to COVID-19.

Additionally, on March 19, 2020, President Trump signed into law the Families First Coronavirus Response Act, which, among other directives, requires health insurance carriers to provide coverage (at no cost-sharing or pre-authorization/medical management requirements) for the testing and administration of U.S. Food and Drug Administration-approved COVID-19 tests.

#### **b. Regulatory Guidance Related to Travel Insurance Coverage**

The COVID-19 pandemic has also caused individuals and businesses to cancel existing travel plans. In response to this disruption to travel, as of March 22, 2020, the NAIC and 18 U.S. state insurance departments have issued guidance to both the insurance industry and consumers regarding travel insurance coverage and COVID-19. The applicable states include: Alabama, Alaska, Arizona, Connecticut, Washington, D.C., Illinois, Iowa, Louisiana, Maryland, Minnesota, Mississippi, Nebraska, Nevada, New York, Ohio, Oregon, Texas and Washington.

This guidance generally provides that unless a previously-held travel insurance policy contains an exception applicable to COVID-19 (e.g., an epidemic or pandemic exclusion), a policy of travel insurance that covers the risks of sickness, accident, or death incident to travel presumptively must cover such risks relating to COVID-19. However, this guidance also generally notes that a travel insurance policy that has been purchased more recently likely will not cover cancellations due to COVID-19 as the disease is now considered a known event.

#### **c. Regulatory Guidance Related to Business Interruption Insurance Coverage**

Additionally, the global COVID-19 pandemic has caused massive disruptions to both large and small businesses, and many will likely be adversely affected for the foreseeable future. In response to the economic consequences triggered by COVID-19, as of March 22, 2020, the NAIC and 11 U.S. state insurance departments have issued guidance to the insurance industry and consumers regarding how COVID-19 implicates business interruption insurance coverage. The applicable states include: Connecticut, Georgia, Kansas, Louisiana, Maryland, Minnesota, New Hampshire, New Jersey, New York, Oregon and South Carolina.

This guidance addresses, among other topics: how the economic consequences of COVID-19 affect a typical business interruption insurance policy; how an official declaration of a state of emergency affects business interruption insurance policies; and how employers' remote work directives affect business interruption insurance coverage.

#### **d. Regulatory Guidance Related to Operational Issues for Regulators, Insurers and Other Regulated Entities**

The societal-wide disruptions caused by the COVID-19 pandemic implicate the operations of both the insurance industry and regulators. In connection with these disruptions, as of March 22, 2020, 18 U.S. state insurance departments have issued materials related to, among other topics: regulatory flexibility on filing deadlines, continuing education requirements for producers and grace periods for premium payments; insurers' plans to deal with financial risk caused by the pandemic; and the fair treatment of insurance consumers during this public health crisis. The applicable states include: Alaska, Arkansas, California, Delaware, Florida, Georgia, Hawaii, Kansas, Kentucky, Maryland, Michigan, Missouri, New Jersey, New York, Pennsylvania, Rhode Island, West Virginia and Wisconsin.

### **B. U.S. FEDERAL ACTIVITY**

#### **1. FSOC — Changes to Non-Bank SIFI Designation Guidance**

On December 4, 2019, the Financial Stability Oversight Council ("**FSOC**") voted unanimously to issue guidance (the "**Guidance**") regarding the designation of non-bank financial companies as systemically important financial institutions ("**SIFIs**"). The Guidance became effective on January 29, 2020 and replaces in its entirety the guidance that FSOC previously issued in 2012. The new Guidance implements an "activities-based approach" for identifying and addressing potential risks to financial stability, with a goal of "enhanc[ing] the analytical rigor and transparency of [FSOC]'s process for designating [SIFIs]" and represents a significant departure from the prior guidance issued by FSOC.

The Guidance condenses the prior three-stage process for a SIFI determination into only two stages. Under the prior stage 1, which the Guidance eliminates, FSOC applied a set of uniform quantitative



metrics to a broad group of non-bank financial companies in order to identify which non-bank financial companies should be further evaluated. In addition to eliminating stage 1, the Guidance makes other procedural changes that are intended to “facilitate [FSOC’s] engagement and transparency.” By making an entity aware early in the review process of certain risks that FSOC has identified, FSOC seeks to provide the entity greater opportunities to mitigate those risks prior to any designation and thereby provide a potential pre-designation “off-ramp.”

The Guidance states that FSOC will pursue an entity-specific determination “only if a potential risk or threat cannot be adequately addressed through an activities-based approach.” The Guidance instructs FSOC to recommend designating an entity a SIFI “only if the expected benefits to financial stability from the determination justify the expected costs that the determination would impose.” In making a potential determination, the Guidance directs FSOC to assess the likelihood of the non-bank financial company’s material financial distress.

The SIFI designations of all four entities previously identified as SIFIs (i.e., MetLife, AIG, General Electric Capital Corporation and Prudential) were previously rescinded. Accordingly, no non-bank SIFI designations currently remain in effect.

## 2. SEC Best Interest Regulation

On June 5, 2019, the SEC adopted four releases 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 issue of the standards of conduct governing advisers and broker-dealers have been discussed for more than two decades. The key aspects of the proposal (Form CRS and Regulation Best Interest) are scheduled to become effective on June 30, 2020, and the SEC appears unlikely to extend this deadline.

The four SEC releases are:

- **Form CRS/Relationship Summary.** This new rule requires broker-dealers and registered investment advisers to provide all retail investors (as defined) with a brief relationship summary at the beginning of a relationship and in connection with any material changes. The summary addresses 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;
- **Regulation Best Interest.** A new rule that requires 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. The rule requires broker-dealers to act without placing the financial or other interests of the broker-dealer or associated person ahead of the retail customer when making an investment recommendation;
- **Investment Adviser Interpretation.** An interpretation of the fiduciary standard of conduct for investment advisers, explaining the SEC’s interpretation of the duty of care and the duty of loyalty; and
- **Solely Incidental Interpretation.** An interpretation of when a broker-dealer’s advice to clients is considered “solely incidental to brokerage” and when that advice crosses over to require registration as an investment adviser.

The obligations under the Regulation Best Interest are 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.
- **Compliance Obligation.** In an enhancement from the original proposal, broker-dealers must establish, maintain and enforce policies and procedures reasonably designed to achieve compliance with Regulation Best Interest.

Notably, Regulation Best Interest does not prohibit a firm from selling higher cost or complex products, including insurance products such as variable annuities, nor does it forbid a firm from having a limited product set, so long as the limitations are clearly disclosed. Regulation Best Interest applies at the time a broker-dealer makes a recommendation to a retail client, and does not establish an ongoing monitoring obligation for broker-dealers.

Regulation Best Interest and the accompanying releases were adopted on a 3-2 vote, with the two Democratic Commissioners dissenting. Several states have filed judicial challenges to Regulation Best Interest for failing to adopt a full fiduciary standard equivalent to the standard for investment advisers. However, most securities industry firms are preparing for Form CRS and Regulation Best Interest on the assumption that it will become effective on June 30, 2020 as scheduled.

Meanwhile, several states, including Nevada, Massachusetts and New Jersey, have proposed enhanced fiduciary standards for broker-dealers and investment advisers which would go beyond Regulation Best Interest, and for investment advisers would impose standards higher than the SEC's fiduciary interpretation. Notably, the NYDFS already has adopted an across-the-board fiduciary standard for both broker-dealers and investment advisers when selling dually regulated insurance and securities products such as variable annuities and variable life insurance policies. See section IV.A.2.b above for more information on New York Insurance Regulation 187 regarding the adoption of the best interest standard. Additionally, the NAIC has amended the Suitability in Annuity Transactions Model Regulation to incorporate a best interest standard for insurance producers making an annuity recommendation to a retail customer. See section IV.A.2.a above for more information on these NAIC activities.

Industry groups have opposed most of these state initiatives, and have argued that the states should wait to consider how Regulation Best Interest is implemented before adopting new standards. The industry groups also have argued that the state proposals are inconsistent with (and therefore are preempted by) the National Securities Market Improvements Act of 1996 and Regulation Best Interest itself.

### 3. Derivative Transactions

#### a. Initial Margin Requirement Phase-In Extended

During 2019, U.S. regulators extended the phase-in period for initial margin rules (the "**IM Rules**") by creating a new "Phase 6" phase-in period that pushes out compliance with the IM Rules to September 1, 2021 for many financial end users that would have otherwise been captured in the September 1, 2020 compliance date. While September 1, 2021 may seem far off, financial end users who are captured by the IM Rules will need to plan well in advance in order to be able to continue trading post-September 1, 2021. Compliance with the IM Rules will 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 a financial end user is subject to the September 1, 2020 "Phase 5" or September 1, 2021 Phase 6 compliance date, a series of calculations are required with respect to the derivatives trading activity of the financial end user during a specified three-month period. Because these calculations are unique to each financial end user, dealers will require financial end users to certify their status during the IM Rules phase-in period. The International Swaps and Derivatives Association, Inc. ("**ISDA**") published a self-disclosure letter that can be used by financial end users to certify their status under the IM Rules and identify whether they expect to be in scope for the September 2020 Phase 5 compliance date or the September 1, 2021 Phase 6 compliance 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>14</sup> with “material swaps exposure.” Accordingly, financial end users will be required to both post, and receive, IM with their swap dealer counterparties. A financial 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 new Phase 5 September 1, 2020 phase-in date applies with respect to financial end users that (along with all of its affiliates) have an AANA in March, April and May of 2020 that exceeds US\$50 billion, otherwise the Phase 6 September 1, 2021 phase-in date will apply to all other financial end users with material swaps exposure.

## 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.

## 4. U.S. Response to Cessation of LIBOR and Transition Risk

Following abuses in the LIBOR market during the financial crisis, the FCA in the UK started to regulate LIBOR, the International Organization of Securities Commissions (“**IOSCO**”) published its “Principals for Financial Benchmarks” and in 2016 the EU adopted its own EU Benchmark Regulations in an effort to create a standard to regulate the use of benchmarks in the EU markets. As a result of these initiatives in Europe, as well as various other factors, it is widely expected that the current LIBOR rates will no longer be available after the end of 2021. This discontinuation will impact LIBOR rates published in the following five currencies: U.S. dollar (“**USD**”), euro, pound sterling, yen and the Swiss franc. In connection with the expected cessation of LIBOR, working groups in each of the U.S., EU, UK, Japan and Switzerland were formed by the relevant regulatory authorities in each jurisdiction, and they have each identified at least one alternative reference rate for each of the five LIBOR currencies expected to be discontinued.

In the U.S., the Alternative Reference Rates Committee has identified the Secured Overnight Financing Rate (“**SOFR**”) as the replacement for USD LIBOR. SOFR is a risk-free rate that is determined based on the cost of overnight borrowing in the collateralized U.S. Treasury securities market. Because SOFR is a risk-free rate and is based on collateralized U.S. Treasury repurchase agreement (“**Repo**”) transactions,

---

<sup>14</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.

there is no credit spread embedded in the rate. Additionally, because SOFR is derived from overnight Repo trades, SOFR is only published on a daily basis. SOFR is calculated and published by the New York Federal Reserve Bank ("**NY Fed**"), which started officially publishing SOFR in April 2018.

As a result of the differences between SOFR and USD LIBOR,<sup>15</sup> they are not easily interchangeable and thus the process of transitioning existing instruments from LIBOR to SOFR will require adjustments in order to equalize the rates and minimize any transfer of value from one party to the other. These adjustments are expected to be comprised of two components, a spread adjustment (to address the credit spread differences between the rates) and compounding (to address the duration differences between the rates). The spread adjustment is expected to be a fixed adjustment that will be determined on a specific date prior to the permanent cessation of USD LIBOR and will be added to the daily SOFR rate for each day.<sup>16</sup> In order to adjust for differences between the daily SOFR rate and a USD LIBOR rate that was calculated for a specified duration (other than daily USD LIBOR), it is expected that the SOFR rate, plus the relevant spread adjustment, will be compounded for each day in the relevant calculation period to achieve a rate for the relevant duration.<sup>17</sup>

It is estimated that USD LIBOR is currently used in over US\$200 trillion of financial instruments. Approximately US\$190 trillion represents OTC and exchange-traded derivatives and the remaining US\$10 trillion is accounted for in various cash products, a significant portion of which have maturity dates beyond the 2021 expected discontinuation date for USD LIBOR. While it is expected that ISDA will publish a protocol that provides an efficient means to amend most, if not all, of the OTC derivatives transactions to provide for a fallback to adjusted SOFR, there is not an equivalent approach available to amending the cash products.

Many existing cash products, such as notes, bonds, ABS and loans (bilateral and syndicated), as well as consumer products such as adjustable rate mortgages ("**ARMs**") and student loans, have some form of fallback language in the contractual documentation that establishes such products. However, most such fallback language was crafted with a view towards a temporary suspension of USD LIBOR, and thus, most fallbacks were not intended to address a permanent cessation. As a result, some fallbacks end up falling back to another LIBOR-based rate,<sup>18</sup> some fall back to the last published USD LIBOR rate,<sup>19</sup> and yet others fall back to a specified alternate base rate, such as the Prime Rate. Because some of these fallbacks will result in a rate that cannot be determined (i.e., another LIBOR-based rate) or in a rate that may be uneconomic for the parties (i.e., an effective fixed rate or Prime Rate), it will be necessary to amend or refinance such transactions in advance of the expected 2021 cessation of USD LIBOR in order to avoid legal or economic problems with such transactions. Amending transactions that have multiple parties (such as syndicated loans), are widely held (such as publicly issued notes, bonds and

---

<sup>15</sup> USD LIBOR is calculated based on the rates charged for USD loans among the banks in the British interbank market, and thus has an embedded credit charge which is based on the perceived credit quality of such banks. Further, USD LIBOR is currently published for various durations, including not only overnight, but also 30 days, 90 days, 180 days and 365 days.

<sup>16</sup> For the derivatives markets, ISDA has engaged Bloomberg Information Services ("**BIS**") to compare the differences between USD LIBOR and the SOFR rate (determined based on historical data provided by the NY Fed) over a period of time, currently, expected to be a five-year lookback, to determine the relevant credit spread adjustment. It is expected that BIS will begin publishing such credit spread adjustment on a daily basis later in 2020, so the market will have time to observe and monitor the rate before it is utilized in connection with a permanent cessation of USD LIBOR.

<sup>17</sup> The compounding approach raises certain challenges with respect to the lending and other markets where it is economically and/or operationally important to be able to ascertain the relevant interest rate at the beginning of a calculation period. Thus, some lending/cash markets are considering the utilization of a compounded SOFR rate for a period prior to the relevant calculation period. For instance, on a monthly pay loan, the actual compounded SOFR rate for the month of January, will be the effective rate utilized to calculate interest for the month of February. This is different from what is being contemplated in the derivatives market where payments are generally paid in arrears and the rate does not need to be known at the beginning of the calculation period, and thus for derivatives transactions the compounded SOFR rate is expected to be based on the compounded SOFR rate during the relevant calculation period.

<sup>18</sup> Many of these fallback provisions contemplate the calculation agent or administrator polling banks in the UK market (or in some instances the New York market) for their individual rates for USD loans in the interbank market. However, it is anticipated that when USD LIBOR is no longer published, banks will also discontinue quoting any such rates, so such polling fallbacks will not result in a fallback rate.

<sup>19</sup> Falling back to the last published USD LIBOR rate has the effect of converting the relevant floating rate instrument into a fixed-rate instrument if publication of USD LIBOR is permanently ceased.



securitizations) or involve consumers (such as ARMs and student loans) poses unique challenges and can take a significant amount of time in order to effect a mutually acceptable amendment — especially to the interest rate.<sup>20</sup>

Because of these challenges, it is important for insurers to fully understand their exposure to USD LIBOR — both on the asset and liability sides of their balance sheets. As part of this assessment, insurers should first analyze all existing USD LIBOR-based financial instruments to ascertain whether they have a current maturity that extends beyond the end of 2021. If so, then those post-2021 maturity financial instruments should be further analyzed to determine what, if any, fallback provisions are already included in those financial instruments. To the extent those post-2021 financial instruments have an existing fallback that produces a non-viable LIBOR-based rate or that a rate that does not work economically for the parties, then such financial instruments should be prioritized for amendment, or refinancing, to the extent possible. While insurers are analyzing their existing USD LIBOR positions, they should simultaneously formulate a USD LIBOR fallback plan for all new transactions that are entered into between now and the end of 2021 that will initially reference USD LIBOR as the relevant interest rate, so that those transactions, as they are entered into, have suitable fallback provisions that will work operationally and economically in the event USD LIBOR is permanently discontinued.

## 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. The UK officially exited the EU at 11:00 p.m. GMT on January 31, 2020, commencing the transition period that will run until December 31, 2020.

Prior to exit day, the UK had 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**") which 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. In October 2019, the EU and UK agreed on a draft withdrawal agreement ("**Brexit Withdrawal Bill**") and the EU agreed to extend Article 50 to January 31, 2020. Following Boris Johnson winning a Conservative majority in the UK general election on December 12, 2019, the Brexit Withdrawal Bill received royal assent (having passed through the UK Parliament) and the European Parliament voted to approve the Brexit Withdrawal Bill, clearing the final hurdle for Brexit to go ahead.

#### b. The Brexit Withdrawal Bill

Although the Brexit Withdrawal Bill lays out the precise terms of the relationship between the UK and the EU immediately after exit day, it is 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 Brexit Withdrawal Bill provides for a transition period which will 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 will no longer be a member of the EU and will have no representation on EU bodies. However, the UK will 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.

Importantly, in the context of the European insurance market, this implementation period will allow for the continuation of "passporting" rights. As such, (re)insurers and intermediaries will be allowed to passport from the UK into the EU and vice versa until December 31, 2020, just as they would have

---

<sup>20</sup> It has also been publicized that some constituents and lawyers are gearing up for challenges to certain financial products which may have an impact on the ability to effect an amendment of such products and thus the ultimate impact of the USD LIBOR transition on such products.

been able to before Brexit. Essentially, the status quo will be preserved while the UK and EU attempt to negotiate their own bespoke trade deal, which will itself address the issue of “passporting” and whether or not this system will be kept in place or replaced by an alternative.

At the time of publication, there is still much uncertainty around how Brexit negotiations will progress during the transition period, and whether or not the UK will leave the transition period with or without a deal.

### c. Option (i): A Trade Deal With the EU is Achieved

It is difficult to predict the impact of what a trade deal with the EU may mean for the insurance industry, as the outcome entirely depends on the forthcoming negotiations between Westminster and Brussels. Issues on the table will include market access, the future regulatory environment, movement of the workforce and the recognition of professional qualifications between jurisdictions. The EU has said that future market access for UK financial firms will be based on “equivalence,” whereby Brussels will grant the UK entry to the European market if it deems the UK’s domestic regulation to be as stringent as the EU’s own regulation. Within the insurance industry, opinion is divided as to how far the UK should diverge from its European counterparts. Some market participants would like the UK to remain closely aligned with the EU in order to ensure as smooth a transition as possible, while others see the UK’s departure from the EU’s regulatory regime as an opportunity for the UK to branch out and devise its own path by becoming a low-tax, low-regulation competitor on the global stage.

### d. Option (ii): “No-Deal” Brexit

If negotiations do not go well, the UK will leave the transition period on December 31, 2020, with no trade deal with the EU. This is commonly referred to as a “no-deal” Brexit. In this circumstance, the provisions of the Brexit 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.

In the context of insurance, the UK 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 came into force following exit day. 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” 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>21</sup> (published in February 2019) that the regulators 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 to alleviate the risk of such firms having to ensure compliance with all the onshoring changes by exit day.

In addition, following the transition period, the working assumption is that the right to passport into the UK will likely be repealed, meaning that firms currently “passporting” into the UK will no longer be able to carry on regulated activities in the UK without full authorization.<sup>22</sup> To combat this, the UK government established the temporary permissions regime (“**TPR**”), which is a scheme for firms that are incorporated

<sup>21</sup> PRA Policy Statement: PS 5/19 on *The Bank of England’s amendments to financial services legislation under the EU Withdrawal Act and the FCA Policy and Statement: PS 19/5 on Brexit Policy Statement and Transitional Directions*.

<sup>22</sup> PRA Supervisory Statement SS1/19 on *Non-Binding PRA Materials: The PRA’s Approach after the UK’s Withdrawal from the EU*.

in the European Economic Area (“**EEA**”) but currently operate in the UK through “passporting” under the existing European passport framework. In the event that the UK leaves the transition period 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 long term to continue operating in the UK for a period of time while they wait to obtain authorization from the UK regulators.

PRA firms (e.g., insurers) were eligible to enter the TPR if: (i) they had applied to the UK regulators for Part 4A authorization on or before April 11, 2019; or (ii) they exercised 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 had elected to enter the TPR, they would have obtained 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 FCA’s deadline for solo-regulated firms (such as insurance intermediaries) was extended to October 30, 2019. Both deadlines for applications for the TPR have now expired and if a firm has not notified the appropriate regulator of their intention to enter the TPR by the deadline, they are no longer eligible to enter the regime. However, in an update on January 31, 2020, the FCA stated that they will “confirm [...] plans for reopening the notification window later this year, which will allow additional notifications to be made by firms and fund managers before the end of the implementation period,” suggesting that there is some scope for additional notifications to be made later this year for FCA solo-regulated firms. The PRA has not yet confirmed if it will re-open its notification window.

The PRA and FCA released consultation papers<sup>23</sup> in October 2018 that outlined the proposed rules and regulations that would apply to firms that enter the TPR. They have since released their Brexit Policy Statements (as referred to above) which contain the near-final rules that will apply to TPR firms. Firms that have gained entrance to the TPR should review these Policy Statements to ensure that they can comply with these rules and regulations, should the TPR come into force following the end of the transition period. 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 regime. 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 the end of the transition period in a “no-deal” scenario. 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 only regulators in the UK 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. In October 2019, EIOPA published member state responses to its February 2019 recommendations. All noted that they either already complied with the recommendation or intended to comply, therefore providing comfort to those UK insurers who have been concerned about their ability to continue servicing their EU policyholders in a “no-deal” Brexit environment.

<sup>23</sup> PRA Consultation Paper: CP 26/18 on *UK withdrawal from the EU: Changes to the PRA Rulebook and onshored Binding Technical Standards* and FCA Consultation Paper: CP 18/29 on *Temporary permissions regime for inbound firms and funds* (FCA).

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

As a result of the uncertainty surrounding Brexit, UK (re)insurers have taken steps to prepare for the possibility of a “no-deal” outcome 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 the transition period.

## 2. Lloyd's Update

In September 2019, Lloyd's launched Blueprint One, its most ambitious set of reforms yet, setting out its vision for modernization of the market with the intention to become, as Lloyd's describes it, “the most advanced insurance marketplace in the world.” The biggest driver for reform is Lloyd's desire to develop an advantage over its competitors in an increasingly crowded market. It aims to achieve this primarily through the digitalization and automation of processes, with the intention that this will reduce costs. Tied in with this is Lloyd's plan to encourage its platforms to trade more simply and efficiently and to become more flexible for capital providers. Blueprint One comprises six “solutions” which will be implemented as part of a three-phase plan, which stretches from January 2020 to January 2022 onwards.

This is not the first time that Lloyd's has claimed its reforms will induce significant change, nor have its initiatives always proved to be successful in the past. However, the latest proposals stand out for being so ambitious and wide-ranging in their application. Lloyd's has raised over £300 million of senior debt to fund Blueprint One, seeking to overcome a large initial barrier to success. The initiative has received a broadly positive response from the industry. Notably, AIG has announced that it intends to double the amount of business it has in the Lloyd's market by establishing Syndicate 2019.

### a. Complex Risk Platform

The first solution in Blueprint One is a complex risk platform, which is a digital platform that complements face-to-face negotiation. In 2020, Lloyd's will begin testing an early build of a document-plus-data solution with a range of market participants, and make a significant financial investment in the existing electronic placing platform (“**PPL**”). Lloyd's issued an updated mandate in January 2020 that sets targets for electronic placement during the first quarter of 2020, with a target for all classes of 80% of “relevant contracts” being placed electronically on PPL.

### b. Lloyd's Risk Exchange

The second solution is a Lloyd's Risk Exchange, which is a digital exchange available to Lloyd's underwriters and coverholders (the Lloyd's equivalent of managing general agents) that will automatically quote, bind and issue for less complex risks, return instant results from rating engines and streamline the processing of binding authority data. The platform will include connection to a Delegated Authority Submission, Access and Transformation Service (“**DA SATS**”) to facilitate straight-through processing of binding authority data. Lloyd's intends that this will create efficiencies in the relationship between syndicates and coverholders. Lloyd's says it will deliver the first set of delegated authority solutions and an early version of the instant quote and bind functionality for a small portion of delegated authority business in 2020.

### c. Claims Modernization

The third solution is another digital solution that automates decision-making for the simplest claims and assists complex claims handling. This solution is intended to enhance the power of lead underwriters to handle and settle complex claims by providing more efficient electronic resources. In 2020, Lloyd's says it will make updates to improve Lloyd's current claims scheme and incorporate automated agreement of low-value payments and an enhanced catastrophe management service. Lloyd's will also pilot new components of the claims solution with a multi-channel interface. The success of this solution will heavily depend on the Lloyd's Risk Exchange and the complex risks platforms for data, and Lloyd's expects to replace the existing Electronic Claims Files platform over time. Lloyd's may find it difficult to draw a line between the automation of simple claims and the more involved approach necessitated by risks of



greater complexity. Furthermore, the automation of claims handling increases the risk of claims leakage and fraud. In developing its claims solution, Lloyd's will need to consult with experienced stakeholders and look to existing technologies to ensure that these problems are effectively preempted.

#### **d. Lloyd's Capital Solution(s) and Other Related Developments**

The fourth solution is a capital solution, which entails making investing in Lloyd's simpler. This involves improved rules and processes and a new digital capital platform, which are intended to improve the experience of existing members and attract new capital providers. The capital platform is planned to match risk and capital with Lloyd's endorsed documentation. In 2020, Lloyd's says it will introduce the platform and new structured investment opportunities, including the first ILS transaction through the new capital solution at Lloyd's. In addition, Blueprint One has proposed the introduction of a lead-follow market model. Under this model, leader syndicates will operate to best practice standards and follow syndicates, while remaining subject to Lloyd's minimum standards, will work within a lower cost structure. Lloyd's theory is that this should boost market performance and increase underwriting standards. However, there is currently uncertainty about certain aspects of the way the model will be implemented, for example, in relation to the regulatory responsibilities of Lloyd's managing agents of the different syndicates. At this stage, the capital solution proposals are quite high level, and clarity will be welcomed in this area as the proposals develop.

Another ongoing, but significant, development taking place this year in the context of capital provision relates to the make-up of eligible Funds at Lloyd's. Lloyd's Market Bulletin Y5117, published on April 12, 2018, implements Lloyd's restrictions on all members' use of Solvency II 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 is taking 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.

#### **e. Syndicate in a Box**

The fifth solution under Blueprint One is Lloyd's "syndicate in a box," which introduces a more efficient way for businesses to enter the Lloyd's market. The initiative has adjusted participation and entry requirements to allow a streamlined approval process, which is billed to take under three months. A syndicate in a box does not require the 20% new entrant uplift, nor for the syndicate to develop an internal model in the early years, and there is the option to defer the Central Fund contribution for three years. This will encourage new syndicates to enter the market, and Lloyd's considers that it has been off to a successful start: in November 2019, Lloyd's announced that it had already received a rush of 80 applications. There are specific rules of participation: the syndicate must be profitable, innovative, developing (producing a gross written premium of up to £100 million in its first year), have limited exposure to Lloyd's peak perils (meaning catastrophe-focused syndicates are precluded) and write shorter-tail risks. Syndicates in a box are subject to the same regulatory responsibilities and Lloyd's minimum standards as for other syndicates. From January 2020, a live syndicate in a box pilot was due to begin operation, Munich Re Innovation Syndicate 1840, and Lloyd's will start considering applications for new syndicates in a box.

#### **f. Services Hub**

The sixth solution in Blueprint One is a services hub that will build on existing capabilities and provide new, innovative services that offer value to market participants and customers.

Following concern from the industry that Lloyd's risks spreading itself too thin with its ambitious and wide-ranging proposals, it announced in February 2020 that it will prioritize improving the Lloyd's claim system, building the complex risk platform and making improvements to how delegating authority business is handled this year. Lloyd's will continue to work on its other more complex projects in the background, as well as the new lead-follow model and data standards.

### g. Other Relevant Developments

In regards to Brexit, as described in this publication last year, 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, although Lloyd's has confirmed that its underwriters will continue to pay all valid claims during the transition period as "passporting" rights will continue to apply during this time.

In 2019, with Lloyd's engaged in its overhaul on profitability, Lloyd's leadership decided that Lloyd's should refocus its attention on U.S. insurers rather than expanding its global footprint. Lloyd's CEO, John Neal, reaffirmed 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. Neal stated, "If you're in insurance or investment banking or banking, one dollar in two dollars of everything you do is still U.S. derived, so it's very important you maintain your connection and your relevance with the U.S. market." Therefore, we expect to see a shift in Lloyd's geographical strategy in the coming year, concentrating even further on the U.S.

Another change introduced during 2019 was Lloyd's consultation on a new approach to third-party oversight within the marketplace. This approach primarily focused on Lloyd's coverholders and third-party administrators (claims handlers). The new rules are due to be introduced in early 2020. They are due to result in: a new risk-based approach to Lloyd's approving delegated authority applications; the requirement that outsourced claims handlers be approved by Lloyd's, and the granting of flexible discretion to firms to delegate without prior approval from Lloyd's and to allow sub-delegation of authority, which was up until now almost completely barred by Lloyd's. This development is intended to tie in with the Lloyd's Risk Exchange and claims electronic platforms, and further affirms Lloyd's commitment to digitalization, increased market efficiency and reducing costs.

Finally, a significant reform in Lloyd's this year is the formation of the Revised Council, proposed to take effect from June 1, 2020, whereby the Lloyd's Franchise Board (which has been Lloyd's key executive body for many years) will be merged into the Council of Lloyd's. Lloyd's stated intention is to ensure the composition is more closely aligned with the UK Corporate Governance Code.

### 3. SM&CR to Be Extended to FCA Solo-Regulated Firms

In July 2018, the FCA published its proposals that the Senior Managers and Certification Regime ("**SM&CR**"), first introduced for banks in 2016 and extended to apply to insurers in December 2018, would be extended to include FCA solo-regulated firms from December 9, 2019. Insurance intermediaries are FCA solo-regulated firms and therefore the SM&CR now applies to them.

Previously, FCA solo-regulated firms were subject to the "approved persons" regime. This has now been replaced by the SM&CR for such firms.

#### a. Scope of the SM&CR

As the SM&CR covers a wide range of differing FCA-regulated firms, the FCA took a different approach than the approach taken for banks and insurers. This was to allow for a more proportionate and flexible regime, that accommodates the various governance structures and business models of the differing firms to which the SM&CR now applies.

Accordingly, the FCA has divided FCA solo-regulated firms into three categories:

- a. **Core firms:** firms that are subject to the core regime and therefore the baseline set of requirements under the regime;
- b. **Limited-scope firms:** firms that are subject to fewer requirements than "core firms." These types of firms are similar to those that were subject to a limited application of the "approved persons" regime; and

**c. Enhanced firms:** large, complex firms that are subject to additional rules.

Most firms are considered core firms with less than 1% falling within the “enhanced firms” category. Most insurance intermediaries fall within the core firms category.

**b. SMFs**

Senior management functions (“**SMFs**”) are allocated to the most senior people in a firm who have greater potential to have an impact on the market integrity of the firm. The list of SMFs are set out in Chapter 10C of the Supervision Part (“**SUP**”) of the FCA Handbook.

The “core” SMFs, such as the chief executive function (SMF1), executive director function (SMF3) and chair function (SMF9), apply to all firms except for “limited-scope firms.” Such firms have fewer senior management functions that apply to them and the types of senior management function that do apply to them may vary depending on the type of firm. For example, the FCA has introduced SMF29 for limited-scope firms, which is a role for individuals at such firms who: (i) are appointed to deal with apportionment of responsibilities and (ii) oversee the establishment and maintenance of controls.

As noted above, enhanced firms are subject to additional requirements under the regime, including: (i) additional senior management functions (such as chief finance function (SMF2), chief risk function (SMF4), etc.); (ii) additional prescribed responsibilities; (iii) the overall responsibility requirement (whereby an enhanced firm needs to ensure that every activity, business area and management function has a senior manager with overall responsibility for it); (iv) a management responsibilities map (which is a single document that sets out the enhanced firm’s management and governance arrangements); and (v) handover procedures (ensuring that any person that takes over a senior manager role has all of the material required to ensure they can perform the role effectively from the start).

Any individual who is allocated a specific SMF is required to be approved by the FCA prior to undertaking this role. Firms should have sought approval for such individuals ahead of the SM&CR’s implementation in December 2019.

**c. Prescribed Responsibilities**

The Senior Management Arrangements, Systems and Controls (“**SYSC**”) Part of the FCA Handbook contains a list of the prescribed responsibilities which a firm must allocate to a senior manager as part of the SM&CR. The aim of these responsibilities is to ensure that at least one senior manager at a firm is responsible for the different aspects of the SM&CR, as well as conduct and prudential risks. The prescribed responsibilities listed in the SYSC apply to all core firms. Similarly to the SMFs noted above, a narrower scope of prescribed responsibilities applies to limited-scope firms and enhanced firms have some additional prescribed responsibilities.

FCA guidance indicates that firms should think carefully about how they allocate prescribed responsibilities to senior individuals by ensuring that the person allocated to that responsibility has sufficient knowledge and authority to carry it out effectively. In addition, each prescribed responsibility should only be held by one person, although there may be limited circumstances where a prescribed responsibility can be shared by more than one person (e.g., where a senior manager’s role is job-shared).

In addition to the above, firms are required to prepare a “statement of responsibilities,” which is a single document that sets out the role and responsibilities of each senior manager in the firm. A firm’s “statement of responsibilities” needs to be approved by the FCA and firms are required to provide updated “statements of responsibilities” to the FCA for additional approval if there are any significant changes to a senior manager’s responsibilities. Chapter 10C of SUP contains examples of what a significant change might be, as well as other rules and guidance relating to the “statements of responsibilities.”

**d. Duty of Responsibility**

The establishment of a statutory “duty of responsibility” is an area that will affect senior managers and directors of insurance intermediaries. If a firm breaches a particular FCA requirement, senior managers responsible for that area will be held accountable if they did not take “reasonable steps” to prevent that breach. The burden of proof lies with the FCA to prove this.

The FCA will look at all of the circumstances when deciding whether to take action against an individual. It may also choose to take action against the firm rather than the senior manager. PS18/16<sup>24</sup> contains final guidance on the FCA's approach to enforcement of the duty of responsibility.

In addition, in PS18/16 the FCA crucially notes that it will use the existing criteria in its Decision Procedure and Penalties Manual to determine whether or not to take action against a senior manager under the duty of responsibility. It notes that statements of responsibility and management responsibilities maps will be relevant when considering the extent of a senior manager's responsibilities, as well as the scale and complexity of the relevant firm's business.

#### **e. Certification Regime**

The certification regime covers certain individuals who are not senior managers but whose role at the firm means it is possible for them to cause significant harm. 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. The certification regime does not apply to non-executive directors; it only applies to employees of the firm.

The certification functions only apply to firms where such functions exist and therefore it is possible that certain smaller firms will not have any individuals performing such functions. The list of certification functions is set out in Chapter 9 of the FCA's Guidance<sup>25</sup> and includes the following:

- Significant management function and CASS oversight function;
- Client-dealing function (which includes individuals who advise on investments, deal in contracts of investments or act in the capacity of investment manager);
- Individuals who are responsible for supervising a certified function but are not themselves a senior manager; and
- Material risk takers (this is a term that already exists for FCA solo-regulated firms but in the context of the FCA's remuneration rules).

In terms of timing, although firms should have identified employees who would need to be certified by December 9, 2019, the actual process of certifying such individuals as fit and proper does not need to take place until December 9, 2020.

#### **f. Conduct Rules**

The new SM&CR conduct rules can be found in the Code of Conduct part of the FCA Handbook. These rules replace the previous *Statements of Principle and Code of Practice for Approved Persons*. The FCA has confirmed that the new conduct rules apply to employees conducting regulated and unregulated financial services activities (including related ancillary activities).

The conduct rules apply to all senior managers, certified function holders, non-executive directors (who are not senior managers) and all other employees (except ancillary staff such as back office staff). The conduct rules are divided into two tiers with Tier 1 conduct rules applying to most employees at a firm and Tier 2 conduct rules applying only to senior managers (in addition to the Tier 1 rules).

Firms are required to train their staff on the applicability of the conduct rules to them such that employees are aware of what the rules mean and how they apply in the context of the firm that they work for. In addition, firms are required to notify the FCA where they take disciplinary action against individuals for conduct rule breaches.

<sup>24</sup> PS18/16 on *Final Guidance: the Duty of Responsibility for Insurers and FCA Solo Regulated Firms*.

<sup>25</sup> *The Senior Managers and Certification Regime Guide for solo regulated firms (Updated July 2019)*.

### g. Next Steps

The SM&CR has applied to FCA solo-regulated firms since December 9, 2019. Accordingly, most firms should have allocated their senior staff to relevant SMF roles and certification roles ahead of this date. Where a firm has not done this or has made amendments to its responsibilities map and the roles that individuals are undertaking at the firm, such modifications should be notified to the FCA as soon as possible.

As noted above, the FCA has allowed additional time for firms to finalize their arrangements for certain aspects of the regime. For example, while firms were expected to know who their certified staff are from December 9, 2019, firms have until December 9, 2020 (i.e., an additional 12 months) to finalize their fitness and propriety assessments of these individuals and submit their certification paperwork to the FCA. In addition, while the conduct rules have applied to senior managers and certified function holders since December 9, 2019, the FCA is giving firms an additional 12 months to train other staff members on the conduct rules.

It should also be noted that some firms still remain outside of the SM&CR. For example, in the context of the insurance market, appointed representatives are not subject to the SM&CR and therefore, the “approved persons” regime still remains in effect for such firms. In addition, the FCA has, since April 2019, taken over the regulation of claims management companies. Given the proximity of this date to the SM&CR application date, the FCA has allowed transitional arrangements for such firms to prepare for and make arrangements to be compliant with the SM&CR. Claims management firms will be deemed to be limited-scope firms and therefore the scope of rules that apply to them is narrower than for most FCA solo-regulated firms.

## 4. PRA Consultation Paper on the Solvency II Prudent Person Principle

On September 18, 2019, the PRA released a consultation paper (CP22/19) (“**CP22/19**”) which outlines the proposed rules and regulations that firms must follow to comply with the Prudent Person Principle (“**PPP**”) investment standard contained in Solvency II. The proposed regulations would apply to all UK Solvency II firms, mutuals, third-country branches, the Society of Lloyd’s and its managing agents. The consultation period closed on December 18, 2019 and, as of the date of this publication, the accompanying policy statement has yet to be released by the PRA.

The PPP, introduced on January 1, 2016 as part of Solvency II, replaces the previous insurance investment rules that applied to supervised firms under Solvency I. The PPP provides a benchmark standard for insurance investments whereby those investments must meet the standard of a prudent person, which provides greater flexibility and freedom for insurance investments than Solvency I’s asset admissibility rules and quantitative limits. However, CP22/19 notes that since Solvency II was introduced, the PRA has observed inconsistencies in the understanding and application of the PPP by supervised firms, as well as emerging issues relating to the PPP as a result of recent changes in the insurance industry. CP22/19 seeks to highlight and clarify those inconsistencies, and to provide the PRA’s proposed minimum expectations for supervised firms’ investment activities, risk management systems and governance frameworks to meet the PPP.

The PRA’s proposed expectations include requirements for firms to develop an investment strategy that documents, among other things, clear investment objectives, asset class allocations and the alignment of such strategy with the firm’s particular business model, internal risk tolerance limits, investment goals and board risk appetite. The PRA emphasizes the responsibility of a firm’s board to review, scrutinize, control and approve material changes to the investment strategy such that those changes continue to comply with the PPP.

The proposed guidelines also provide detailed expectations relating to a firm’s investment risk management. The PRA’s proposed rules provide that compliance with the PPP requires firms to develop risk management frameworks that will allow a firm to determine appropriate investment limits based on the firm’s solvency needs. A firm’s risk management activities should include identifying and analyzing a range of scenarios that may cause investment risks to crystallize and the firm’s responses to those scenarios. Firms should quantify the potential impact of those scenarios on the firm’s solvency position



and its ability to pay policyholders before and after management actions. Supervised firms are expected to comprehensively monitor their investments for breaches of internal limits on assets and exposures, as well as material changes in asset characteristics, values and volatility, credit spread and default risk.

Under the proposed guidelines, firms will be expected to maintain properly diversified risk portfolios and to demonstrate that internal limits in a firm's investment risk management policy are justifiable in light of the firm's particular risk characteristics and investment strategy. Internal investment limits should be developed with consideration given to factors such as the firm's risk management capabilities, the need for proper diversification of assets and uncertainty on the valuation of assets, and should "encompass at least asset class, geographic, single-name, sector and off-balance sheet exposures that the firm would expect to hold in reasonably foreseeable market conditions." The PRA expects firms to demonstrate proper diversification through stress tests of the portfolios, and more specifically expects that exposure to a single source of risk will not threaten the solvency risk appetite of the firm in a moderate stress scenario nor the solvency of the firm in a severe stress scenario.

CP22/19 also discusses changes observed within the insurance industry, such as the increasing investment by life insurers with annuity books in non-traded assets, and the likelihood for PPP concerns to subsequently arise from those investments. The PRA's proposed guidelines provide that firms investing in non-traded assets are expected to thoroughly assess the risk of those investments, and specifically to keep levels of investment in non-traded assets to a prudent level. Firms should thoroughly consider the valuation uncertainty and liquidity challenges associated with non-traded assets. Firms should also ensure that their internal rating systems and valuation methodologies are robust, and that internal quantitative limits for non-traded assets are developed with particular care. The PRA expects the skills and expertise of the individuals internally valuing non-traded assets to be commensurate with the complexity of such assets and the materiality of the firm's exposure to such assets.

Additionally, the proposed guidelines require that assets backing technical provisions are invested in the best interests of the policyholders, not shareholders. CP22/19 pays particular attention to intra-group loans which may not meet this standard, and advises that a supervised firm's board should be satisfied that all conflicts of interest are resolved prior to the investment in an intra-group asset, and that such investment is in the best interest of the policyholders.

While CP22/19 introduces specific actions that the PRA expects firms to take to meet the PPP, the PRA recognizes that investment risks and strategies, and compliance with the standard, will vary based on the nature and characteristics of each firm. While supervised firms still have the flexibility to exercise a broad range of investment, risk management and governance strategies, CP22/19 clarifies a number of aspects of an insurer's investment activities. CP22/19 provides that the PRA will exercise its independent judgment when determining whether a firm meets the PPP and that where the PRA finds that the standard has not been met, the PRA will expect the firm's senior functions to take corrective actions. While the final policy statement has not yet been published, supervised firms' senior functions, including chief risk officers, should take this period to review their firm's investment, risk management and governance strategies and to bring these in line with the proposed expectations of the PRA.

## 5. Cyber Risk

In 2019, the UK continued to address issues arising from the dynamic nature of cyber risk and the uncertainties stemming from both non-affirmative and affirmative cyber insurance coverage. During the past year, steps were taken by each of the PRA, FCA, Lloyd's and EIOPA, among other organizations, to further clarify issues related to cyber risk exposures, to move market participants away from non-affirmative (or "silent") and endorsement-based cyber coverage and to encourage insurers' improved operational resilience and management of responses to potential cyber risks. Generally, commentators have noted that the cyber market is becoming increasingly competitive, with cyber sales motivated by news of cyber-related losses. Over the next year, firms should expect to see additional initiatives by supervisory and advisory bodies relating to cyber risk, as well as continued movement towards greater alignment in the understanding of different cyber issues among various industry participants and across jurisdictions.

### a. Cyber Insurance Market

In 2019, the cyber insurance market, regulators and industry participants continued to focus on the proper management of non-affirmative cyber risk exposures. As non-affirmative covers cause uncertainty for insurers and policyholders alike, it remains important for insurers and underwriters to actively manage the potential cyber liabilities that may inadvertently arise in traditional classes of business insured and to bring clarity to those policies.

In an effort to achieve greater management of non-affirmative cyber coverages, Lloyd's published a Market Bulletin on July 4, 2019 (the "**July Market Bulletin**") to provide clarity for Lloyd's customers regarding those exposures. The July Market Bulletin mandates underwriters and managing agents to ensure that all policies, including reinsurance policies, either exclude or provide affirmative coverage for cyber risk. Lloyd's views all policies where no exclusion exists and there is no express grant of cyber coverage as non-affirmative subject to the requirements contained in the July Market Bulletin. This initiative continues to build upon related market research and market surveys completed by Lloyd's in the past two years, and will occur in a phased approach with four stages for implementation of these requirements. The first phase requires underwriters to exclude or provide affirmative cyber coverages in all first-party property damage policies incepting on or after January 1, 2020. According to a Market Bulletin published on January 29, 2020 (the "**January Market Bulletin**"), phase two applies to classes including accident and health, political risk and property catastrophe excess-of-loss with policies incepting on or after July 1, 2020. Phase three applies to classes including directors and officers, financial institutions, medical malpractice and professional indemnity and applies to policies incepting from January 1, 2021, and phase four applies to business such as casualty treaty, medical malpractice and employers' liability with policies incepting on or after July 1, 2021. Lloyd's will monitor compliance with such requirements in connection with its regularly planned scheduled oversight activities.

However, despite initiatives such as the above, commentators note that the market continues to struggle to address a number of the unsettled issues with respect to silent cyber, including consistent understanding and application of definitions related to cyber coverage. Following the July Market Bulletin, Lloyd's Market Association published two bulletins at the end of last year to introduce model cyber exclusion and endorsement clauses developed to minimize these issues and to provide clarity of cyber coverage under policies. These model clauses are available on Lloyd's Wordings Repository and provide a consistent starting point for underwriters. The International Underwriting Association of London engaged in a similar effort to rectify the inconsistent application and understanding of relevant cyber definitions. In June 2019, the organization published two London market model clauses to assist underwriters to better manage unintended or unclear non-affirmative cyber risk cover. The model clauses include a Cyber Loss Absolute Exclusion Clause, which provides the broadest possible exclusion of any loss arising out of a computer system, computer network or data, each of which is clearly defined, and a Cyber Loss Limited Exclusion Clause to exclude only losses directly caused by cyber events.

With respect to the affirmative cyber market, while interest in purchasing standalone cyber policies increased due to news reports of ransomware attacks and other cyber-related losses, pricing uncertainty and lack of understanding of coverage remained two of the key challenges facing insurers in 2019. Accurate pricing remains an open question with current premiums for cyber insurance set low due to the market's lack of long-term loss ratios, historic data and legal precedent. For example, though the EU General Data Protection Regulation 2016/679 ("**GDPR**") was introduced in 2018, insurers have since struggled to properly price affirmative cyber policies containing data privacy elements as there have only been a limited number of sanctions for breaches imposed under the GDPR to date. In regards to coverage, there is no consistent understanding across the market with respect to the question of whether certain losses, such as funds transfer fraud loss or cyber-related bodily injury or physical loss, should be covered under a dedicated cyber policy or a crime or property policy. Finally, there continues to be skepticism of the overall value of cyber coverage, in part based on a lack of fulsome historical loss scenarios and misinformation regarding cyber-related claims rejected under non-cyber policies.

Industry commentators note that as cyber is not a mature product and is rapidly evolving, the market will need to continue to work to better understand the insurability of the associated risks. Market participants should continue to develop a comprehensive understanding of the potential costs of cyber risks and value of cyber coverages, particularly as standalone affirmative cyber policies become more commonplace.

## **b. PRA, FCA and EIOPA Initiatives and Communications**

Based on publications by the UK and European regulatory and advisory bodies over the past year, firms should expect that there will be continued appetite in 2020 for improved clarity and consistency in operational resilience and cyber risk supervision and standards in the market. Steps towards greater alignment and refinement of approaches to cyber risk and cybersecurity can be expected as regulators continue communication to establish more standards, regulations and guidance.

### **i. PRA**

In June 2019, following its January 2019 Dear CEO letter addressed to chief executives of regulated insurance firms, the PRA initiated an exploratory cyber stress test as part of its 2019 General Insurance Stress Test. The cybersecurity underwriting loss scenario was developed with the aim of collecting information on how firms are currently managing and preparing to respond to cyber risks, which are particularly difficult to assess, and the placement of the loss scenario in the exploratory section of the test “reflect[s] a lack of common taxonomy and approach in assessing this risk within industry.” The submission deadline for the stress test closed on October 31, 2019, and the PRA plans to publish a Dear CEO letter with the aggregate findings from the stress test sometime during the first quarter of 2020.

### **ii. FCA**

In March 2019, the FCA issued a publication discussing industry insights on the topic of cybersecurity, which followed from its 2017-2018 survey and November 2018 speech addressing cyber and technology resilience in UK financial services. While the publication notes it will be particularly useful for small to medium-sized enterprises, the FCA provides that the examples and practices set forth are beneficial for a wider audience.

This publication summarizes best cyber practices and experiences of the survey respondents, which comprise over 175 firms across different financial sectors. Among many other insights, the publication discusses the importance of good governance, such as the use of a top-down approach where cyber is put on the executive agenda and considered in connection with enterprise risk management. Surveyed firms also emphasized the importance of identifying critical business services and business interconnectivity at risk, investing in cybersecurity and training, establishing and utilizing an effective cyber risk-monitoring regime, seeking additional information on new and emerging cyber threats, incorporating response and recovery plans into the firm’s risk management and operational resilience planning, and forming and refining a comprehensive cyber testing framework. Regulated firms should consider the practices discussed in the publication in developing and improving their internal cyber defense and resilience frameworks.

Additionally, in December 2019, following from a related discussion paper published in 2018, the FCA published consultation paper CP19/32 (“**CP19/32**”) to address proposed changes to how regulated firms approach their operational resilience. The FCA defines operational resilience as “the ability of firms and the financial sector as a whole to prevent, adapt, respond to, recover and learn from operational disruptions.” In CP19/32, the FCA proposes that regulated firms take steps to enhance operational resilience by, among other things, identifying important business services that if disrupted are at risk of causing harm to consumers or market integrity, mapping the components of important business services, setting limits for maximum disruptions to business services, stress and disaster testing, creating self-assessment documents, developing communication plans for use during disruptions, and conducting lessons learned exercises on the firm’s ability to effectively recover from disruptions. As the consultation period for CP19/32 closes on April 3, 2020, it is likely that the FCA will publish its corresponding policy statement and supervisory statement in the latter half of the year.

### **iii. EIOPA**

In September 2019, based on responses from over 40 large (re)insurance groups across 12 European countries, EIOPA published a report of the challenges and opportunities relating to cyber risk for insurers. This report discusses how the use of a consistent set of terminology and definitions, as well as clear and common requirements on cybersecurity governance, could benefit the European insurance sector. Additionally, it introduces suggestions to improve the resilience of the insurance sector as a whole against cyber risks, such as the use of a streamlined and consistent cyber incident reporting framework. The report also provides observations about the European cyber insurance industry generally, noting

that many factors are expected to increase demand for cyber insurance in the future, identifying non-affirmative exposures as a continued source of concern, and discussing the need for improvement in the industry's data collection and risk assessments.

Additionally, on December 12, 2019, EIOPA launched a consultation on proposed guidelines for information and communication technology ("**ICT**") security and governance (the "**Draft Guidelines**"). The Draft Guidelines, which are open for public consultation until March 13, 2020, note "the complexity of ICT is increasing and the frequency of ICT related incidents (including cyber incidents) is also on the rise, as is the detrimental impact of such incidents on undertakings' operational functioning." As such, EIOPA view "ICT and security risk management [as] fundamental for an undertaking to achieve its strategic, corporate, operational and reputational objectives."

The Draft Guidelines, which will enter into force from July 1, 2020 following the public consultation and adoption by the EIOPA Board of Supervisors, aim to limit regulatory arbitrage and avoid the exploitation of loopholes in a currently fragmented EEA/UK regulatory framework on ICT security and governance. This consultation is directed to both market participants and national supervisory authorities.

## 6. Other UK Regulatory Developments

In November 2019, the PRA published a letter written to CEOs of general insurers regulated by the PRA which outlined the PRA's areas of focus over the coming year: (i) reserve adequacy and associated reserving governance and controls; (ii) discipline in underwriting strategies; (iii) exposure management practices; (iv) understanding UK retail general insurers' responses to the FCA's pricing practices review; and (v) firm culture, which is of "deep concern" to the PRA. The PRA's supervisory focus over the next few months will include discussions with firms to understand how they are addressing these issues to the extent relevant to their business, and for management teams to identify actions they believe should be taken for their firm.

The PRA's focus on culture highlighted in its November 2019 letter has been echoed by the FCA, and the UK regulators are working closely together to respond to the allegations of sexual harassment and bullying within the industry that have been publicized over the past year. In January 2020, the FCA published a letter to CEOs of UK insurers in relation to non-financial misconduct. The letter emphasizes that firms should be proactive in tackling such issues by embedding healthy cultures and identifying and modifying the key drivers of their culture. Poor culture in financial services can lead directly to harm to consumers, market participants, employees and markets, a theme reiterated in the FCA's thematic review and finalized guidance in relation to the general insurance ("**GI**") distribution chain (described below).

In a speech delivered in June 2019, the PRA indicated that instances of non-financial misconduct could impact its view of the fitness and propriety of individuals within the SM&CR, which has been extended to FCA solo-regulated firms as of December 2019 (see section IV.C.3 above for further detail on this topic). In addition, the speech emphasized the intention of the supervisory authorities to make impactful change in regard to diversity and inclusion in the insurance industry, which will be another area of focus during the coming year. Lloyd's is also taking steps to overhaul its workplace culture following the exposure of inappropriate behavior within the corporation last year: culture was highlighted as an area of development in Blueprint One, and in February 2020 Lloyd's established an independent culture advisory group and hired a mental health expert to help to transform the workplace. The PRA, the FCA and Lloyd's will collaborate to monitor progress within firms closely to ensure demonstrable improvements in firm cultures and inclusivity.

Operational resilience is another regulatory area that will see collaboration between the UK's supervisory authorities over the coming year. Operational resilience is the ability of firms, financial market infrastructures ("**FMI**s") and the financial sector as a whole to prevent, adapt, respond to, recover and learn from operational disruptions. The PRA, FCA and Bank of England published a joint Discussion Paper (the "**DP**") in July 2018 to start a dialogue with the financial services industry on this topic. In response to industry feedback received from the DP, in December 2019, the supervisory authorities published a suite of "**Proposals**" that would embed that approach into policy. The Proposals will comprise new rules for the FCA and PRA, principles, expectations and guidance, and will be implemented through the regulators' respective supervisory areas. The intended result of implementing

the Proposals is that when a disruption occurs, firms and FMs will have robust and reliable arrangements in place to deal with it. The regulators are coordinating a joint effort in order to develop an approach that is aligned as far as practicable.

To complement the Proposals, the PRA has published a Consultation Paper (the “**CP**”) entitled *Outsourcing and third party risk management*.<sup>26</sup> The CP reinforces the PRA’s expectation that firms should ensure that their important business services are able to remain within their impact tolerances even when they rely on outsourcing or third-party providers. In the CP, the PRA invites comments on its proposals for modernizing the regulatory framework on outsourcing and third-party risk management, set out in a draft Supervisory Statement. The PRA proposes to publish its final policy on the proposals in the CP in the second half of 2020 (in line with the final policy on operational resilience), with implementation of most of the proposals shortly after.

In other significant developments, in April 2019, the FCA published its Thematic Review (TR19/2) on GI distribution chains. The report is the culmination of two simultaneous but separate reviews, one of which focused on value in the GI distribution chain, and the second of which assessed whether outsourcing firms had implemented effective risk management and control frameworks to mitigate the risks highlighted by the FCA’s 2015 review. The 2019 review is relevant to all firms in the GI sector. The FCA highlighted three examples of possible harm to customers: (i) excessive prices; (ii) unsuitable products; and (iii) customers not receiving the services they need and experiencing poor outcomes. The FCA considers the two primary causes of these potential harms to be: (i) firms having a purpose and culture with insufficient focus on customers, particularly in relation to value and customer outcomes; and (ii) poor governance and oversight or product design, manufacture and distribution processes and practices (both over firms’ own business activities and where these were undertaken by other parties in the distribution chain).

The FCA subsequently published its finalized guidance (FG19/5) entitled, *The GI distribution chain: Guidance for insurance product manufacturers and distributors* in November 2019. The guidance aims to provide clarity to firms in the GI and pure protection sector about the FCA’s expectations, in particular on the design and distribution of insurance products and the requirement to act in accordance with the customer’s best interests. The guidance is applicable to all firms who conduct the following regulated activities: (i) insurance distribution activities; (ii) effecting or carrying out contracts of insurance; and (iii) managing the underwriting capacity of a Lloyd’s syndicate or a managing agent at Lloyd’s. Insurance product manufacturers are required to put in place a product approval process, covering product design and review, during which the FCA expects the manufacturers to consider the value that the product presents for its intended customers and how the distribution chain affects overall value. The FCA expects insurance product distributors to consider the impact that their distribution strategy and remuneration has on the overall value of the product to the customer. Firms must ensure that the remuneration they receive for their insurance distribution activity does not conflict with their duty to comply with the customer’s best interests. Distributors are required to monitor the products they offer, and their distribution arrangements, on an ongoing basis. When distributors identify that a product is resulting in customer harm, they should inform the manufacturer and, if necessary, amend the way they distribute the product.

Insurers’ product design, sales and claims management processes could be affected by the FCA changing its regulatory approach to an outcomes-based system rather than focusing on compliance with specific rules. In a speech delivered in October 2019, the FCA’s executive director of strategy and competition stated that the FCA’s current regulatory regime cannot accommodate the changing context of insurance regulation, noting that while the FCA considers that the first wave of post-financial crisis regulation has achieved its aims, there has been a change in consumer needs and attitude, and innovation has gathered pace. In 2020, the FCA says that it will seek to engage with market participants to hear their views on the regulatory model they would like to see moving forward, and the regulator will publish detailed papers, including an analysis of future market dynamics, a Discussion Paper about the FCA’s Principles (its core regulatory expectations of firms), and a Consultation Paper on the “Duty of Care.” It will also explore the possibility of simplifying and streamlining its rulebook through its “Handbook Review.”

Finally, the UK regulatory regime may be affected over the coming year by EIOPA’s 2020 Solvency II Review (the “**2020 Review**”). EIOPA published its consultation paper on the 2020 Review in October

---

<sup>26</sup> The FCA CP, published as part of the Proposals, also contains a chapter on outsourcing.



2019, and the consultation period ended in January 2020. EIOPA plans to publish its Opinion on the 2020 Review in June 2020. The proposals contained in the consultation paper take the approach of “evolution rather than revolution” and expand upon earlier recommendations and advice provided by EIOPA in relation to the Solvency II regime. Key proposals encompass: (i) resolving deficiencies in the volatility adjustment; (ii) group supervision; (iii) reporting; (iv) the establishment of a recovery and resolution framework; and (v) introducing a macroprudential perspective within Solvency II. The proposals are far-reaching but the final reforms that will result from the 2020 Review depend on how the European Commission chooses to respond to EIOPA’s recommendations. Therefore, whether the 2020 Review will lead to minimal or radical change remains to be seen. Further, at the pan-European regulators’ annual conference in December 2019, the head of the European Commission’s insurance and pensions unit reportedly stated that the EU is unlikely to adopt the proposed changes to the bloc’s insurance capital requirements rulebook before the end of 2022. It is not clear to what extent the UK regulatory framework will incorporate any EU-level changes now that the UK has exited the EU (see section IV.C.1 above for further detail on the UK regulatory implications of Brexit). The PRA has suggested that it will consider whether specific UK concerns about Solvency II are addressed in the 2020 Review. One area where the reforms are lacking is in relation to the risk margin, to which no changes have been proposed by EIOPA, and which may lead to the UK adopting an approach that is ultimately out of line with the EU.

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

Similar levels of enforcement activity were seen in 2019 by the European Commission (“**Commission**”), the Court of Justice of the European Union (“**CJEU**”) and the General Court (together, “**EU Courts**”). Likewise, the enforcement actions of national competition authorities throughout the EU remained broadly in line with the previous year.

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

#### i. European Commission

In February 2019, the Commission launched a “fitness check” on its major State aid tools, including its communication on short-term export credit insurance from 2012. The goal was to evaluate whether those State aid rules have actually worked in the way intended and if they are still fit for purpose. As part of the fitness check, the Commission ran a public consultation between April and July 2019 to gather stakeholders’ views on the effectiveness and efficiency of the State aid rules under review. The adoption of new instruments is planned for the third quarter of 2020.

In May 2019, the Commission opened proceedings against Insurance Ireland, an Irish association of motor insurance companies and agents, for allegedly preventing newcomers from accessing its data pooling system, Insurance Link, under equal conditions. The Insurance Link system stores insurance claims data entered by association members and serves two purposes: (i) facilitating the detection of potential fraud, and (ii) ensuring the accuracy of information provided by potential customers. The disputed conduct allegedly placed newcomers at a competitive disadvantage vis-à-vis rivals that already had access to the system in violation of Article 101 TFEU.

In November 2019, the Commission restored Greece to the list of “marketable risk” countries for short-term export credit insurance, effective January 1, 2020. Export-credit insurance enables exporters established in one member state to insure their receivables against commercial and political risks arising on sales to customers in other member states. The Commission considers this risk to be marketable (i.e., capable of being covered by private insurers, meaning there is no need for State support). In 2013, the Commission temporarily designated Greece as a “non-marketable risk” country, allowing member state support without breaching State aid rules. After Greece rejoined the list of “marketable risk” countries on January 1, 2020, State support for short-term export credit risk insurance for Greece may once again constitute unlawful State aid.

In May 2019, the Commission concluded that State aid granted by the Greek government in 2014 and 2015 to the National Bank of Greece (“**NBG**”) remains compatible with EU State aid rules. This was on the basis of a new set of commitments given by the Greek government. The State aid granted also covered NBG’s insurance business, Ethniki Insurance, which NBG had initially committed to sell before 2017, though without success. In the current commitments package, NBG renewed its efforts to sell at least 80% of Ethniki Insurance by the end of 2020.

## ii. EU Courts

In April 2019, the CJEU delivered a ruling in response to a question from the Supreme Court of Poland regarding the principle of *ne bis in idem* (“the rule against double punishment”) in relation to fines imposed on a Warsaw-based insurer for alleged abuse of a dominant position. The CJEU held that EU competition law did not preclude the Polish Competition Authority from imposing concurrent fines for breaches of both national competition law and EU competition law, the former occurring before Poland’s accession to the EU, and the latter following accession. However, the CJEU cautioned that where an authority imposes two fines under national and EU antitrust rules for the same material act, it must ensure that “taken together, the fines are proportionate to the nature of the infringement.”

In May 2019, the General Court dismissed an action by a French reinsurer to annul a decision by the Commission approving as compatible with State aid rules an unlimited guarantee by the French state to the Central Reinsurance Fund for its natural disaster reinsurance activities. The General Court found that the applicant had no standing to contest the merits of the Commission’s decision and rejected the applicant’s claim that the Commission had failed to follow the correct procedure.

In December 2019, the CJEU’s Advocate General Priit Pikamäe delivered an Opinion supporting an appeal by the Commission and the Slovak Republic against a General Court ruling from February 2018 which held that not-for-profit State-owned health insurers were subject to State aid rules because they were engaged in an “economic activity” and were therefore “undertakings” under EU competition rules. Advocate General Pikamäe argued that the General Court had erred in finding that (i) the presence of profit-making private insurers on the market, and (ii) the existence of competition between private and State-owned operators, were sufficient to conclude that activities carried out within the Slovak health insurance system were “economic” in nature, despite its “predominant, social, solidarity and regulatory features.” The CJEU will rule in due course.

## b. National Level Enforcement in the UK

### i. FCA Publishes Final Report on Wholesale Insurance Brokers Market Study

In February 2019, the FCA published the final report on its Wholesale Insurance Brokers market study, finding no evidence which would support the introduction of intrusive remedies. The FCA stated it will continue working with firms on areas of concern, including conflicts of interest, disclosure of information and contractual arrangements between brokers and insurers.

### ii. FCA Publishes Report on the General Insurance Distribution Chain

In April 2019, the FCA issued a warning to general insurers regarding the need to provide value for money to consumers. The FCA raised concerns about the length of the insurance distribution chain and the associated price increases which, in the absence of additional benefits for consumers linked to these increases, may lead to unfairly excessive prices.

### iii. FCA Continues Its Probe Into Discrimination in Insurer Pricing Algorithms

In July 2019, the FCA published a feedback statement on its assessment of fair pricing in the insurance market. Although the FCA did not think that insurers were intentionally discriminating against consumers, it indicated it had suspicions that the data underpinning pricing algorithms may not comply with the Equality Act, and may demonstrate a racial bias.

## c. National Level Enforcement in Belgium

In 2019, Belgian consumer organization, Test Aankoop/Test Achats, turned its focus to the excessive pricing of drugs paid for through insurance. As part of its investigations, the organization filed two complaints with the Belgian competition authority, l’Autorité belge de la Concurrence, alleging that two pharmaceutical manufacturers had abused their dominance by charging excessive prices for drugs.

## d. National Level Enforcement in Bulgaria

In October 2019, the Bulgarian Commission for Protection of Competition (“**BCPC**”) blocked the acquisition by EuroHold Bulgaria AD, a publicly traded Bulgarian asset manager and non-life insurer, of the Bulgarian subsidiary of CEZ Group, the Czech Republic’s largest electricity producer. According to the BCPC, the transaction raised concerns about conglomerate effects.

#### e. National Level Enforcement in Denmark

In December 2019, the Danish Consumer and Competition Authority ("**DCCA**") published its findings following a two-year pension sector inquiry. The DCCA found that there were real restrictions to competition in the non-statutory pensions market, and identified steps to ensure that company pension schemes, which typically comprise cheap insurance products and expensive asset management, are run more efficiently and priced more cost-effectively.

#### f. National Level Enforcement in Finland

In February 2019, the Finnish Competition and Consumer Agency ("**FCCA**") terminated its investigation into OP Financial Group ("**OP**"), concluding it had found no evidence that the group's bonus scheme was restricting competition in the non-life insurance market. A rival had complained that OP was abusing its dominant position by tying its non-life insurance services and the retail bank services provided by individual cooperative banks through OP's bonus scheme.

#### g. National Level Enforcement in France

In July 2019, France's prudential regulator, l'Autorité de Contrôle Prudentiel et de Résolution ("**ACPR**"), warned 18 French life insurers that they could face sustained low returns in the future. The ACPR advised that setting a technical interest rate in excess of 1.5% could expose life insurers to ongoing low returns if current low market interest rates were to persist.

In October 2019, the ACPR instructed insurance distributors to update their telephone sale practices. Distributors are required to provide quality advice to customers and make proper recordings of telephone sales calls to protect the interests of elderly and vulnerable customers.

In December 2019, the French competition authority, l'Autorité de la concurrence, approved a merger between La Banque Postale S.A. and CNP Assurances S.A. The authority found that there were sufficient competitors on the insurance market that no competition concerns were raised.

#### h. National Level Enforcement in Germany

In April 2019, the German competition authority, the Bundeskartellamt ("**BKartA**"), published a report indicating that comparison websites have violated consumer rights in a number of sectors, including the insurance industry. In particular, the BKartA found that insurance comparison sites frequently do not include key providers, resulting in a lack of transparency for consumers.

#### i. National Level Enforcement in Ireland

In December 2019, Ireland's Competition and Consumer Protection Commission ("**CCPC**") announced that its investigation into the motor insurance market was close to completion. As part of its probe, the CCPC is investigating whether the sharp price increase in motor insurance premiums in Ireland is linked to price-signaling conduct between major industry providers.

In August 2019, the CCPC launched a market study into Ireland's public liability insurance sector. The CCPC indicated that it is not investigating breaches of competition law. The goal is to contribute to the Irish government's efforts to bring about changes in the sector.

#### j. National Level Enforcement in Latvia

In June 2019, the Latvian Competition Council ("**LCC**") concluded a market study into Latvia's third-party liability insurance market. The LCC indicated that there is excessive transparency in the market, which allows tacit coordination among providers. As a remedy, the LCC has proposed setting a cap on insurance premium offers to protect consumers from excessive price increases.

#### k. National Level Enforcement in Netherlands

In December 2019, the Dutch Authority for Consumers and Markets ("**ACM**") issued a policy paper setting out the situations in which it will refrain from enforcing competition rules and imposing fines on certain beneficial collaborations between healthcare providers and health insurers. The ACM's new

policy is part of an initiative called “The Right Care in the Right Place,” which aims to make high-quality healthcare more accessible. The policy paper follows a public consultation with input from participants across the healthcare sector earlier in 2019.

### **l. National Level Enforcement in Portugal**

In August 2019, Portugal’s competition authority, Autoridade da Concorrência (“**AdC**”), concluded a cartel investigation into five insurance companies which were coordinating on prices for workplace accident, health and auto insurance to large corporate customers. The AdC imposed fines of €54 million on four of the companies, the highest ever fines in the Portuguese financial sector. The fifth company avoided a fine as it was the first to make a leniency request.

### **m. National Level Enforcement in Romania**

In April 2019, the Romanian Competition Council (“**RCC**”) carried out dawn raids at the headquarters of several insurance companies suspected of engaging in anti-competitive practices. This enforcement action was an extension of a wider investigation by the RCC, which started in 2017, into competition in the motor vehicle maintenance services market.

### **n. National Level Enforcement in Sweden**

In June 2019, the Swedish Competition Authority (“**SCA**”) published a report on the auto insurance and auto repairs market in Sweden. The SCA found that insurance companies reduce the ability of car owners to choose repair shops, steering them towards authorized shops. This hampers the ability of independent repair shops to compete. The report examines the effects of this practice on competition among auto repair shops.

## **8. Impact of EU and UK Data Privacy Developments on the Insurance and Reinsurance Industry**

The GDPR entered into force on May 25, 2018, imposing significant obligations on (re)insurers.

The initial intention of the GDPR was to create a harmonized approach to data protection compliance across the EU. However, as the GDPR approaches its two-year anniversary, it has become clear this is not the case. In particular, the conditions for processing special category personal data, most notably health data and personal data relating to criminal convictions, differ across the EEA/UK. This is of particular relevance for the (re)insurance industry in the context of the provision of health, life and motor insurance. We set out below some of the key issues for the (re)insurance industry in 2020.

### **a. GDPR Enforcement and Fines**

Under the GDPR, national data protection authorities (“**DPA**s”) have the power to impose administrative fines of up to 4% of a company’s annual worldwide turnover (gross revenue) or €20 million, whichever is higher. In addition, DPAs also have significant investigative and corrective powers, including the ability to impose a temporary or definitive ban on processing personal data, or to order the suspension of data flows to a third country (for example, Bermuda or the Cayman Islands).

During 2019, there were numerous GDPR fines imposed on companies by DPAs in the EEA/UK. In relation to the UK, the Information Commissioner’s Office (“**ICO**”) in July 2019 issued an intention to fine:

- An airline £183.39 million for inadequate security measures following a cyber attack, which resulted in user traffic to the airline’s website and mobile application being diverted to a fraudulent website where names, postal addresses, email addresses and payment card details of customers were compromised; and
- A hotel chain £99.2 million for inadequate security measures following a cyber attack affecting approximately 339 million guest records, of which 30 million related to residents in 31 countries in the EEA and seven million related to UK residents. The inadequate security measures originated out of a vulnerability in the information security systems of a company the hotel chain had acquired in 2016, with the compromise to customer personal data remaining undetected until 2018. In its investigation, the ICO highlighted the hotel chain’s poor due diligence of the information security systems of the target company prior to the acquisition.

Given the large amount of personal data and sensitive personal data held by the insurance industry, having robust security measures in place within (re)insurers are of critical importance, in light of DPAs' scrutiny of companies' security measures and likely enforcement action for inadequate security.

Further, given the prevalent use of data sets for modeling risks and the nature of insurance policies and how long they might be in issue for, (re)insurance companies should review how they comply with the GDPR's storage limitation principle (e.g., personal data should not be kept in a form which permits identification of data subjects for longer than is necessary for the purposes for which personal data are processed).

In November 2019, the Berlin DPA ("**the Berlin Commissioner**") announced it had fined a property rental company €14.5 million for storing tenant personal data, including health insurance data, on an archiving system from which it was difficult to delete such data, and without verifying if such data was permitted to be stored, or even required. Further, the Berlin Commissioner highlighted that in certain individual cases, years-old personal data of tenants were preserved despite no longer being necessary for the purpose of their original collection. Importantly, the Berlin Commissioner recommended all controllers check their archiving systems for compatibility with the GDPR.

DPAs have also started taking GDPR enforcement actions against companies in the (re)insurance industry, for example:

- In 2018, the Dutch DPA ("**AP**") imposed penalties on two Dutch health insurers for inadequate security measures to protect personal data. In its investigation, the AP found that the marketing personnel of both insurers had access to the medical data of policyholders. The AP imposed corrective penalties on both insurers, in order to ensure their internal systems were updated to prevent further unauthorized access to insured medical data. One of the insurers failed to comply with the order and was issued a €50,000 fine. Notably, under the GDPR, data subjects have the right to be represented by not-for-profit bodies, organizations and associations who can lodge complaints with DPAs on their behalf regarding the protection of their personal data. Interestingly, the above-mentioned AP fines originated as a result of an enforcement request from Vrijbit, a Dutch privacy rights association, alleging unauthorized processing of medical data in the Dutch health insurance industry; and
- In August 2019, the ICO ordered an insurer to respond to a data subject exercising their right of access to their personal data.

## b. Profiling and Artificial Intelligence

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 an individual, in particular to analyze or predict aspects concerning that individual'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, them unless the profiling (a) is necessary for the performance of a contract; (b) has been authorized by an EEA member state or UK law; or (c) is conducted with their explicit consent, and appropriate safeguards are implemented.

This right may have a significant impact on the (re)insurance industry, as the underwriting process uses platforms that are designed to systematically process information about individuals and make certain predictions in order to price risk and allocate premiums. In addition, the (re)insurance industry uses big data projects to assist in market analyses, targeted marketing and fraud detection, and all forms of automatic processing. (Re)insurers should review their current profiling activities to ensure compliance with the GDPR, in particular, in light of growing regulatory scrutiny.

In July 2019, EIOPA set up an expert working party group ("**Consultative Expert Group**") to look at digital ethics in insurance following a review of the use of big data analytics in the motor and health insurance industry. The Consultative Expert Group will review different areas of the insurance value chain, with specific focus on pricing, underwriting and the impact of big data analytics on certain groups of vulnerable consumers.



On February 19, 2020, the European Commission published a white paper on artificial intelligence calling for a regulatory framework on the use of artificial intelligence to examine “whether current legislation is able to address the risks of AI and can be effectively enforced” while leaving “room to cater for future developments.” The paper is open for public consultation until May 19, 2020.

In addition, the ICO in February 2020 also launched a public consultation on its draft artificial intelligence auditing framework, aimed at compliance officers (e.g., data protection officers and general counsel) and technology specialists, to assess risks that artificial intelligence can pose to the rights and freedoms of individuals and appropriate measures to adopt to mitigate such risk. The ICO’s public consultation closes on April 1, 2020.

### c. Accountability and the GDPR

A growing area of focus by DPAs is the principle of accountability, that is, companies being able to demonstrate how they comply with the many requirements of the GDPR. These requirements include, for example, the requirement for companies to implement data protection policies, maintain a detailed record of processing activities, conduct data protection impact assessments and implement data protection by “design” and “default” (“**DPbDD**”) when processing personal data.

In November 2019, the European Data Protection Board (“**EDPB**”), the EU-wide data supervisory authority, published draft guidelines on DPbDD which encourage early adoption of DPbDD when processing personal data, in particular requiring companies to comply with the GDPR data protection principles (e.g., data minimization and storage limitation) at the outset of the processing activities. Importantly, under the guidelines, controllers are expected to be able to demonstrate measures and safeguards to achieve DPbDD (e.g., a reduction of complaints and response time when data subjects exercise their rights).

Since the entry into force of the GDPR, many companies are now undertaking a review of the work carried out in the run-up to May 2018 to assess their compliance and accountability under the GDPR and to re-evaluate certain decisions which, in many cases, were made in a rush to meet the May 2018 deadline. This is of particular importance, given the rise in global privacy laws with similarities to the GDPR (e.g., the CCPA and the exercise of data subject rights). (Re)insurers should see the rise in global privacy laws as an opportunity to review their GDPR and broader privacy compliance programs, and leverage work undertaken as part of their initial GDPR project to ensure a smooth and GDPR-consistent implementation for compliance with global privacy laws.

### d. Brexit

As discussed in section IV.C.1 above, the UK left the EU on January 31, 2020 under the terms of the EU (Withdrawal Agreement) Act 2020. The EU (Withdrawal Agreement) Act 2020 implements the Brexit Withdrawal Agreement, a treaty agreed between the EU and the UK, into UK domestic law. Under the Brexit Withdrawal Agreement, there is a transition period until December 31, 2020, during which time EU law will continue to apply in the UK. During the transition period, personal data flows between the EU and the UK will remain unrestricted.

In anticipation of the UK’s departure from the EU, the UK government passed into UK law the Data Protection, Privacy and Electronic Communications (Amendments etc.) (EU Exit) Regulations 2019 (the “**Regulations**”). The Regulations amend the UK Data Protection Act 2018, which entered into force on May 23, 2018 to supplement the provisions of the GDPR into UK law, to ensure UK data protection law functions effectively post-Brexit.

In particular, the Regulations maintain the extra-territorial application of the GDPR. Under the Regulations, a UK-equivalent to the GDPR (“**UK GDPR**”) is created. Under the UK GDPR, businesses, such as (re)insurers established in the UK or (re)insurers established outside of the UK who process personal data of individuals in the UK to provide insurance services, will be subject to the UK GDPR. In turn, the UK GDPR requires that such (re)insurers established outside of the UK appoint a data protection representative (“**DPR**”) in the UK.

The Regulations concerning the UK GDPR do not enter into force in UK law until January 1, 2021 (the end of the current transition period). The first round of negotiations on the UK's future relationship with the EU took place in early March 2020, but subsequent rounds have been postponed due to the outbreak of COVID-19. As such, this position is subject to change and should be closely monitored by (re)insurers.

#### e. Transfers of Personal Data From the EEA/UK

The GDPR imposes a general prohibition on the transfer of personal data to countries outside the EEA/UK that are not considered to have an adequate level of protection. There are certain exemptions under the GDPR from this data transfer prohibition, including:

- Where certain data protection safeguards have been adopted (such as the data exporter in the EEA/UK and the data importer outside the EEA/UK entering into EU Standard Contractual Clauses — also known as “Model Contracts”); or
- Where a derogation in the GDPR from the prohibition applies (such as where the data subject has explicitly consented to the transfer).

In July 2019, the CJEU began to hear arguments challenging the validity of Model Contracts. The hearing arose following a referral by the Irish High Court requesting a preliminary ruling on the validity of Model Contracts, with the referral following a complaint made to the Irish DPA by the privacy rights activist Max Schrems. On December 19, 2019, the advocate general (“AG”) to CJEU issued a non-binding advisory opinion that Model Contracts were a valid transfer mechanism to transfer personal data outside of the EEA/UK. However, in his opinion, the AG noted the decision to use Model Contracts should be assessed on a case-by-case basis, considering factors including, without limitation, “the nature of the data and whether they are sensitive [and] [...] mechanisms employed by the exporter and/or the importer to ensure its security.” A final decision by the CJEU is expected in mid-2020. Given the prevalence of Model Contracts within the insurance industry, the CJEU's ruling should be closely monitored.

#### f. Business Marketing

Where a company processes personal data of individuals in the EEA to market services by phone, email, text or fax, it is not only subject to the GDPR but also the EU Directive 2002/58/EC of the European Parliament and of the Council of July 12, 2002, concerning the processing of personal data and the protection of privacy in the electronic communications sector (more commonly known as the “e-Privacy Directive”). Where personal data is used to market services to individuals in the UK, companies are also subject to the UK Privacy and Electronic Communications Regulations (“**PECR**”).

Under PECR, companies cannot send email marketing to individuals unless: (i) they have received the individual's consent; or (ii) the individual is an existing customer who has bought (or negotiated to buy) a product/service.

An additional exemption of relevance to the reinsurance industry given its business model is the business-to-business (“**B2B**”) exemption, where companies are able to send email marketing to other companies (including limited liability partnerships) without satisfying the above PECR requirements. However, recipient companies should still be provided with the identity of the sender and a valid email address to unsubscribe from emails.

In addition, as good business practice, (re)insurers should maintain a “do not email” list of companies who opt out of B2B marketing, and screen any direct B2B marketing lists obtained from third parties against the do not email list.

#### g. 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 (for example, to process claims), appropriate contractual provisions are in place as required under the GDPR.

Notably, there has been a rise in recent case law where the CJEU has found two or more parties involved in the processing of personal data to be “joint controllers” rather than a controller or processor or independent controllers. In a recent case, the CJEU held a religious community were joint controllers with a group of individual worshippers who were engaged in door-to-door knocking, ruling the preaching was “organised, coordinated and encouraged” by the wider religious community and noting joint controllership did not necessarily constitute “equal responsibility” between various stakeholders.

Given the close relationships within the insurance industry between (re)insurers, insurance brokers and intermediaries, (re)insurers should review agreements with such parties to ensure there is a clear definition of: (i) the roles and responsibilities when processing personal data; (ii) the apportionment of liabilities; and (iii) the mechanisms to resolve disputes. Importantly, under the GDPR, individuals can claim compensation against each of the controllers in a “joint-controllership” for non-compliance with relevant GDPR requirements when processing their personal data.

## **h. Privacy Rights and Privacy Litigation**

Under the GDPR, individuals in the EEA/UK have significant rights in relation to their personal data, subject to certain exemptions, including the right:

- To request access to their personal data;
- For a copy of their personal data to be provided to a third party;
- To correct errors to their personal data;
- Of erasure of their personal data;
- To restrict the processing of their personal data;
- To object to the use of their personal data where it is based on the controller’s legitimate business interests or for direct marketing; and
- Not to be subject to automated decision-making if the decision produces legal or other significant effects that affect them.

Under the right of erasure, where a controller is required to erase personal data which has been made public, the controller must take reasonable steps to inform other controllers (for example, intermediaries and cedent insurers) that are processing such personal data that the individual has requested the erasure by the 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 the right of erasure, and when the exemptions 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.

Further, under the GDPR, individuals are able to claim for “material or non-material damage” as a result of breaches of the GDPR in relation to the processing of their personal data. There has been a sharp increase in data subjects exercising their privacy rights and a significant growth in privacy litigation. In October 2019, the English High Court granted a group litigation order, approving a mass legal action from over 500,000 customers of an airline seeking damages as a result of a compromise to personal data (see section IV.C.8.a above). A deadline for affected data subjects to join the claim has been extended to January 17, 2021, with the total amount of claimants likely to rise and public reports of estimated payouts reaching £3 billion.

(Re)insurers should be aware that breaches of the GDPR could not only result in enforcement action from DPAs in the EEA/UK, but potential litigation from affected data subjects.

### i. 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, have been costly. Given recent GDPR enforcement actions and regulatory attention towards areas relevant to the insurance sector, for example, how big data sets are used for pricing and underwriting, the (re)insurance industry will need to continue its efforts to achieve GDPR compliance (whether in the form of policy, procedural, technological or other changes) and compliance with privacy and security requirements globally, as failure to do so can result in significant sanctions and liabilities.



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

### A. U.S. TAX ISSUES

#### 1. Impacts of COVID-19

The Coronavirus Aid, Relief, and Economic Security ("**CARES**") Act includes a number of provisions aimed at relief for corporate taxes. These include:

- Postponing the deadline for estimated tax payments.
- Increasing the 10% limitation for charitable deductions to 25% of taxable income.
- Relaxing the current net operating loss ("**NOL**") rules to allow carry-back of NOLs from 2018 through 2020 for five years, and to eliminate the limitation on using carry-backs and carry-forwards to 80% of taxable income.
- Increasing the 163(j) limitation on business interest expense from 30% to 50% of "adjusted taxable income."

In addition, the CARES Act contains fixes to perceived technical errors not directly related to COVID-19 relief. This is a quickly developing area.

#### 2. Tax Reform

As reported in last year's *Sidley Global Insurance Review*, the Tax Cuts and Jobs Act ("**TCJA**"), enacted in December 2017, represented the most significant effort at tax reform since 1986 and contained a number of provisions specific to the insurance industry. A discussion draft of a "technical corrections" bill to correct errors in the TCJA was released a year ago by the highest-ranking Republican on the House Ways and Means Committee, Kevin Brady (R-TX), but Congress showed no appetite for taking up tax technical corrections. During 2019, the second year since the enactment of the TCJA, the Treasury and the Internal Revenue Service ("**IRS**") continued to issue guidance implementing the TCJA on issues of particular interest to the insurance industry. The most significant of these are discussed below.

#### 3. Base Erosion and Anti-Abuse Tax

The TCJA introduced a "base erosion" minimum tax that is imposed on corporations, generally at a 10% tax rate, 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%.

In last year's edition of the *Sidley Global Insurance Review*, we identified notable guidance from proposed regulations on the application of the BEAT (the "**2018 Proposed Regulations**"). On December 6, 2019, the Treasury issued final regulations (the "**Final Regulations**") that were generally consistent with the 2018 Proposed Regulations. The Final Regulations contain several noteworthy items:

- The Final Regulations include a reinsurance claims exception from the definition of "base erosion payment." The exception generally provides that amounts paid or incurred by a U.S. insurance company to a related "regulated foreign insurance company" for losses incurred under section<sup>27</sup> 832(b)(5), or claims and benefits incurred under section 805(a)(1), are not treated as "base erosion payments." This exception is sensible because reinsurance is generally priced on a basis intended to be profitable such that the reinsurance arrangement, taking into account the inbound reinsurance premiums, would not be expected to erode the U.S. tax base. This specific exception also assures that life and non-life companies are treated similarly with respect to outbound claims, even though life insurance companies are allowed a "deduction" for such claims while non-life insurance companies account for claims as a reduction of underwriting income — a technical difference that led some to argue that non-life companies did not really need this exception. The Final Regulations further provide that

*...the Tax Cuts and Jobs Act ("TCJA"), enacted in December 2017, represented the most significant effort at tax reform since 1986 and contained a number of provisions specific to the insurance industry.*

*During 2019, the second year since the enactment of the TCJA, the Treasury and the Internal Revenue Service ("IRS") continued to issue guidance implementing the TCJA on issues of particular interest to the insurance industry.*

<sup>27</sup> Unless otherwise stated, all references to "section" herein are to a section of the Internal Revenue Code of 1986, as amended (the "**Code**").



such claims are excluded from the denominator of the “base erosion percentage” (similar to how “qualified derivative payments” and certain foreign currency losses are treated under the Final Regulations).

- b. The Final Regulations follow the approach of the 2018 Proposed Regulations by prohibiting netting of reinsurance items. Many commenters had urged the Treasury to permit netting so that only a related foreign reinsurer’s profit — and not the entire gross reinsurance premium going outbound — would be treated as an erosion of the U.S. tax base, better reflecting economic reality. Other commenters argued vigorously against netting. The Final Regulations generally provide that amounts incurred under a reinsurance contract are not netted for purposes of determining the amount of a “base erosion payment” unless netting would otherwise be permitted for U.S. federal income tax purposes.
- c. In response to comments that the application of the BEAT to consolidated groups may be incompatible with the framework applicable to life/non-life consolidated groups, the Treasury and the IRS reserved on guidance and are continuing to analyze the interaction between these sets of rules.

The Final Regulations apply to taxable years ending on or after December 17, 2018. However, taxpayers may apply the Final Regulations for taxable years ending before this date.

The Treasury also released additional proposed regulations on December 6, 2019 (the “**2019 Proposed Regulations**”). The 2019 Proposed Regulations do not specifically address insurance matters, but they do provide guidance on the determination of gross receipts and the “base erosion percentage” of an “aggregate group.” The 2019 Proposed Regulations also provide that a taxpayer’s foregone deductions will be not be treated as “base erosion tax benefits” if the taxpayer waives the deductions for U.S. federal income tax purposes and follows specified procedures. A taxpayer that would still be in a no-income-tax position for a given year even without the waived deductions might wish to take advantage of this provision to avoid incurring BEAT for that year. Commenters have, again, raised the question whether outbound reinsurance premiums are technically “deductions” eligible for the proposed waiver for non-life insurance companies, life insurance companies, both, or neither. If final regulations provide for a voluntary waiver it should be made equally available to both life and non-life insurance companies. Finally, the 2019 Proposed Regulations contain guidance with respect to the application of the BEAT to partnerships.

The 2019 Proposed Regulations would generally apply to taxable years beginning on or after the date such regulations are finalized.

#### 4. Treatment of Insurance Companies Under the PFIC Proposed Regulations

Section 1297 defines a “passive foreign investment company” (“**PFIC**”) as a foreign corporation, 75% or more of the gross income of which is “passive income” or 50% or more of the assets of which is assets producing, or held for the production of, “passive income” (informally, so-called “passive assets”). After the TCJA, “passive income” does not include income derived from the active conduct of an insurance business by a “qualifying insurance corporation” (“**QIC**”). A QIC is defined as a foreign corporation that would be subject to tax under Subchapter L if it were a U.S. corporation and whose insurance liabilities constitute more than 25% of its total assets.

On July 11, 2019, the Treasury and the IRS released long-awaited proposed regulations on the PFIC rules (the “**PFIC Proposed Regulations**”). The scope of the PFIC Proposed Regulations is broad even with respect to insurance matters, but the following items are particularly noteworthy:

- a. For purposes of the “active conduct” requirement, the PFIC Proposed Regulations adopt a hybrid approach that applies both a facts and circumstance standard, and a bright-line rule. Under the facts and circumstances standard, a QIC actively conducts an insurance business only if its officers and employees carry out “substantial managerial and operational activities.” In limited circumstances, a QIC can include the activities of officers and employees of related entities if a control test is satisfied.

Under the bright-line rule, a QIC also needs to have an “active conduct percentage” (“**ACP**”) of at least 50% to treat its insurance income as per se active. If the ACP is less than 50%, then all of the QIC’s insurance income is treated as per se passive.<sup>28</sup>

The ACP is an approximation of the insurance and investment activities conducted by the QIC’s in-house personnel, as measured by expenses. It is calculated according to the following fraction:

Numerator	Denominator
QIC’s <b>Total Expenses for In-House Services</b> Related to the Production or Acquisition of Premiums and Investment Income on Assets Held to Meet Obligations under Insurance, Annuity, or Reinsurance Contracts Issued or Entered Into by the QIC	QIC’s <b>Total Expenses for In-House and Outsourced Services</b> Related to the Production or Acquisition of Premiums and Investment Income on Assets Held to Meet Obligations Under Insurance, Annuity, or Reinsurance Contracts Issued or Entered Into by the QIC

The Treasury’s emphasis on procuring services from full- or part-time employees rather than independent service providers is contrary to many widespread practices in the industry regarding outsourcing of investment management, brokerage and other services. Many commenters objected on the basis that the Code does not contain such a requirement, and that companies long considered to be engaged in the active conduct of an insurance business could fail the test if these standards were adopted.

- b. Separate from the “active conduct” requirement, the PFIC Proposed Regulations also provide guidance on the application of the “alternative facts and circumstances” test under the definition of a QIC. A foreign corporation with insurance liabilities equal to less than 25% of its assets can still be treated as a QIC if, among other requirements, the failure to meet the 25% threshold is due solely to “runoff-related” circumstances. To establish a failure due to runoff-related circumstances, the PFIC Proposed Regulations require a foreign corporation (i) to be in the process of terminating pre-existing insurance or reinsurance operations, and (ii) to refrain from issuing new contracts (except for required renewals), in each case, pursuant to a plan of liquidation. Commenters have questioned whether the plan of liquidation requirement should be removed because a company in runoff may not consider itself to be operating pursuant to a plan of liquidation.
- c. The PFIC Proposed Regulations provide that a QIC may treat the income or assets of a subsidiary as used in the active conduct of an insurance business only if the assets and liabilities of the subsidiary are included on the QIC’s “applicable financial statement.” Foreign insurers that are not consolidated with their subsidiaries for accounting purposes may be disadvantaged by this requirement.
- d. The PFIC Proposed Regulations introduce the concept of a “qualifying domestic insurance corporation,” the income and assets of which are treated as per se active. Commenters had positive reactions to this addition because it assures that U.S. insurance companies (which are ineligible for QIC status under the Code definition) are treated the same as foreign insurance companies that would be subject to tax under Subchapter L. In last year’s *Sidley Global Insurance Review*, we noted surprising unintended results under the PFIC rules of the TCJA; those problematic results would likely be addressed by this new concept.

The PFIC Proposed Regulations would not be effective until the date the Treasury adopts them as final. However, until final regulations are adopted, taxpayers can apply the PFIC Proposed Regulations to all open tax years, provided that they apply the rules consistently.

<sup>28</sup> Similarly, if the ACP is equal to or greater than 50%, all of its assets available to satisfy liabilities related to the insurance business will be treated as held for the production of per se active income.

## 5. P&C Loss Reserve Discounting

Just in time for P&C insurers to file their first income tax returns under the TCJA amendments, the Treasury issued final regulations addressing how the TCJA changes to loss reserve discounting would be implemented.

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.

Proposed regulations, issued November 7, 2018, were met with heavy criticism because the Treasury proposed to determine discount rates by reference to yields on certain corporate bonds having maturities between six and 17.5 years. Critics pointed out that the proposal was 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 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.

The final regulations (Treasury Decision 9863) issued effective June 17, 2019, responded to this critique by using a corporate yield curve for maturities between 4.5 and 10 years. Shortly thereafter, the IRS published revised loss reserve discounting factors (Revenue Procedure 2019-31) and a simplified procedure for insurers to obtain automatic consent to change their methods of accounting for loss reserve discounting, to comply with the TCJA and the final regulations (Revenue Procedure 2019-30).

## 6. Guidance on Reserves of Life Insurance Companies

On August 6, 2019, the IRS released guidance for how life insurance companies may obtain automatic consent to change their method of accounting to comply with the TCJA changes addressing reserves for life insurance, annuity and certain other products under section 807 of the Internal Revenue Code (Revenue Procedure 2019-34). While this guidance was largely as expected, the American Council of Life Insurers (ACLI) filed a comment letter to urge that future IRS guidance on reserves of life insurance companies give due respect and deference to statutory reserves, citing section 811(a) of the Internal Revenue Code. That provision states that life insurance company tax items are to be computed in a manner consistent with NAIC accounting except to the extent a provision of the Code requires otherwise. Thus, ACLI observed that statutory reserves must be the starting point for reserve items under Code section 807, with tax reserves departing from statutory reserves only to the extent section 807 clearly requires.

### 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**”), with the support of the G20, 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>29</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. Work continues in respect of the

<sup>29</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>.

implementation of the BEPS final recommendations, as well as further BEPS initiatives such as the OECD's Pillar One and Pillar Two projects (commonly referred to as "BEPS 2.0"), and there are likely to be further BEPS-related developments in the future.

### 1. Modification of Tax Treaties: Multilateral Instrument

The 15th and final of the OECD's BEPS action items is a "multilateral instrument" ("**MLI**") to facilitate countries' modifications of their existing bilateral treaties. In principle, if two countries are both signatories to and have ratified the multilateral convention, the double tax treaty between those two countries is automatically modified to reflect the terms of the MLI. The MLI allows each signatory to choose from a framework of pre-agreed options for modifying their existing bilateral treaties to incorporate the OECD's recommended terms.

Of note to insurance companies, the multilateral instrument implements the OECD's recommendations in action item six, aimed at preventing persons from obtaining the benefits of a double tax treaty 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, at the choice of the relevant signatory:

- a. A principal-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;
- b. 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
- c. A combination of the PPT and a simplified version of the LOB.

To date, over 90 countries have signed the multilateral instrument including Canada, Germany, Guernsey, Ireland, the Isle of Man, Jersey, Luxembourg, Switzerland and the UK. However, less than half have actually deposited the instrument of ratification required for the MLI to enter into force in respect of that jurisdiction. In terms of timing, the MLI will enter into effect in a jurisdiction: (i) in respect of taxes withheld at source, on January 1 in the year following ratification; (ii) in respect of all other taxes, six months after ratification; or (iii) at such other time as determined by a contracting jurisdiction. Consequently, insurance companies are encouraged to review: (a) their existing reliance on tax treaty benefits; (b) whether the parties to such tax treaties have become signatories to the multilateral instrument; and (c) which of the proposed modifications have been selected by such jurisdictions from the options set out at a.-c. above.

## C. UK/EU TAX DEVELOPMENTS

### 1. Brexit and Tax

As discussed in section IV.C.1 above, following the triggering of Article 50 of the Treaty on European Union on March 29, 2017, the UK withdrew from the EU on January 31, 2020. A "transition period" is expected to run until December 31, 2020 (although it should be possible to extend this period by mutual agreement between the UK and the EU), during which time a trade deal is being negotiated. The tax implications of any agreement on the future relationship between the UK and the EU (if any) are uncertain.

However, it is expected that UK companies are likely to 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 value-added tax ("**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 likely lose its ability to input into EU tax policy, which could affect entities outside the EU (e.g., the proposed financial transactions tax).

## 2. EU Blacklist and New 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. There have been subsequent modifications to the EU Blacklist, most recently on February 18, 2020, such that the current list includes only American Samoa, the Cayman Islands, Fiji, Guam, Oman, Palau, Panama, Samoa, the Seychelles, Trinidad and Tobago, the U.S. Virgin Islands and Vanatu. Importantly, 47 jurisdictions were originally placed on the so-called “greylist,” representing those countries that avoided the EU Blacklist due to commitments to (a) improve transparency, (b) improve fair taxation, (c) improve substance requirements, and/or (d) apply certain OECD BEPS minimum standards. Similarly to the EU Blacklist, the greylist was most recently modified on February 18, 2020, such that it now includes only 13 jurisdictions.

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 introduced similar legislation. Notwithstanding the implementation of this new legislation, the measures introduced by the Cayman Islands were perceived to be deficient by the EU and, consequently, the Cayman Islands was added to the EU Blacklist at the latest update on February 18, 2020. Although Bermuda was placed on the EU Blacklist in March 2019, it was subsequently moved to the greylist in May 2019. Since then (as of February 18, 2020) the EU has removed Bermuda from the greylist.

Although it is generally expected that the Cayman Islands will be working with the EU to be removed from the EU Blacklist at the next available opportunity, the potential sanctions that could apply to groups concerned in arrangements involving entities based in blacklisted jurisdictions should not be ignored.

Existing sanctions include restricted access to EU funding and an increased risk of audit by tax authorities. However, a list of more penal sanctions, known as “legislative defensive measures,” have been recommended by the EU, and member states have agreed to implement at least one of these measures by January 1, 2021. These include, for example, the imposition of withholding taxes, and the denial of tax deductions, on payments made to entities based in blacklisted jurisdictions.

The EU Blacklist has also been incorporated into other areas of EU legislation. By way of example, there are stricter reporting requirements required under the EU Directive on mandatory automatic exchange of information in the field of taxation in relation to reportable cross-border arrangements (commonly referred to as “DAC 6”) where a deductible cross-border payment made to an associated enterprise resident in a blacklisted jurisdiction is automatically reportable.

The EU has indicated that, from 2020, the EU Blacklist will be updated twice a year.

## 3. 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 ATAD 2 in their domestic law by January 1, 2020 (except for certain measures relating to reverse hybrid mismatches, which must be implemented by December 31, 2021).

# Offices

## BEIJING

Suite 608, Tower C2  
Oriental Plaza  
No. 1 East Chang An Avenue  
Dong Cheng District  
Beijing 100738  
+86 10 5905 5588

## BOSTON

60 State Street  
36th Floor  
Boston, Massachusetts 02109  
+1 617 223 0300

## BRUSSELS

NEO Building  
Rue Montoyer 51  
Montoyerstraat  
B-1000 Brussels  
+32 2 504 6400

## CENTURY CITY

1999 Avenue of the Stars  
Los Angeles, California 90067  
+1 310 595 9500

## CHICAGO

One South Dearborn  
Chicago, Illinois 60603  
+1 312 853 7000

## DALLAS

2021 McKinney Avenue  
Suite 2000  
Dallas, Texas 75201  
+1 214 981 3300

## GENEVA

Rue du Pré-de-la-Bichette 1  
1202 Geneva  
+41 22 308 0000

## HONG KONG

39/F, Two Int'l Finance Centre  
Central, Hong Kong  
+852 2509 7888

## HOUSTON

1000 Louisiana Street  
Suite 5900  
Houston, Texas 77002  
+1 713 495 4500

## LONDON

70 St Mary Axe  
London, EC3A 8BE  
+44 20 7360 3600

## LOS ANGELES

555 West Fifth Street  
Los Angeles, California 90013  
+1 213 896 6000

## MUNICH

Maximilianstraße 35  
80539 Munich  
+49 89 244 409 100

## NEW YORK

787 Seventh Avenue  
New York, New York 10019  
+1 212 839 5300

## PALO ALTO

1001 Page Mill Road  
Building 1  
Palo Alto, California 94304  
+1 650 565 7000

## SAN FRANCISCO

555 California Street  
Suite 2000  
San Francisco, California 94104  
+1 415 772 1200

## SHANGHAI

Suite 2009  
5 Corporate Avenue  
150 Hubin Road  
Shanghai 200021  
+86 21 2322 9322

## SINGAPORE

Level 31  
Six Battery Road  
Singapore 049909  
+65 6230 3900

## SYDNEY

Level 10, 7 Macquarie Place  
Sydney NSW 2000  
+61 2 8214 2200

## TOKYO

Sidley Austin Nishikawa  
Foreign Law Joint Enterprise  
  
Marunouchi Building 23F  
4-1, Marunouchi 2-chome  
Chiyoda-Ku, Tokyo 100-6323  
+81 3 3218 5900

## WASHINGTON, D.C.

1501 K Street N.W.  
Washington, D.C. 20005  
+1 202 736 8000

# SIDLEY

AMERICA • ASIA PACIFIC • EUROPE

[sidley.com](http://sidley.com)

Attorney Advertising - Sidley Austin LLP, One South Dearborn, Chicago, IL 60603. +1 312 853 7000. Sidley and Sidley Austin refer to Sidley Austin LLP and affiliated partnerships as explained at [www.sidley.com/](http://www.sidley.com/) disclaimer. Prior results do not guarantee a similar outcome.

MN-12630-03/20