

C orporate nsurance

The financial crisis and proposed regulatory reforms over the past year have created a climate for uncertainty and change in the insurance area. While the past year can be described as eventful, it may be just the beginning of more significant events to come. Below we set forth industry trends and items to watch in 2010.

Notable Pending Federal Legislation Affecting the Insurance Industry

Health Care Reform. As 2010 begins, the House and the Senate have each passed a health care reform bill, with many of the same provisions but with several key differences. These key differences will need to be ironed out in order for a final bill to be passed and the recent election of Scott Brown to the Massachusetts Senate seat may stall the bill's progress. As the regulatory systems and rules change, health insurers, health maintenance organizations and self-insured employers must be cognizant of the interplay between federal and state regulation.

Insurance Antitrust Exemption Under Scrutiny. The Senate majority leader has already announced his support for legislation introduced by Senate Judiciary Chairman Patrick Leahy that would repeal the federal antitrust exemption for health and medical malpractice insurers. This comes after a prior bill introduced in 2007, which sought a broader repeal of the antitrust exemption for insurers, failed to pass Congress. Momentum for repeal of the antitrust exemption for at least health and medical malpractice insurers appears to be gaining significant traction, and its inclusion in the broader health reform legislation is a distinct possibility as negotiation on a final bill continues.

Financial Regulatory Reform-Impact on the Insurance Industry

The Treasury Department's proposal for the most significant financial regulatory overhaul since the Great Depression was released in 2009, and bills in both the House of Representatives and the Senate are pending that would significantly reshape the financial regulatory landscape. The overwhelming view is that changes to our financial regulatory system need to occur, and the insurance industry will not be immune to such action. Financial regulatory reform includes a number of notable proposals that affect the insurance industry, including the following:

Systemic Risk Regulator. A proposal to regulate systemically important institutions has the potential to affect insurance holding companies and insurance subsidiaries, as questions remain as to the extent to which large insurers or reinsurers will be subject to this new systemic risk regulator. At this point, there is no consensus as to the federal entity to be charged with regulating such firms, whether it be the Federal Reserve or some new Council of regulators. An additional concern is that insurers could be subject to potential assessments to pre-fund the resolution fund for those systemically important firms, even though insurers already pay for their own resolution fund at the state level through guaranty fund assessments.

Office of National Insurance. The proposals contemplate a new Federal office of insurance charged with coordinating international insurance and recommending ways to modernize insurance regulation. The office would also have the authority to enter into international agreements. It remains to be seen how broad the agency's authority will be to preempt state insurance laws that are inconsistent with international agreements that it negotiates. However, regardless of its powers, the creation of any type of federal office of insurance represents a significant change in a state-regulated industry and a diminution of the McCarran-Ferguson Act.

Notable Pending Federal Legislation Affecting the Insurance Industry (cont'd.)

Financial Regulatory Reform-Impact on the Insurance Industry (cont'd.)

New Consumer Financial Protection Agency (CFPA). There is a proposal to create a new consumer financial protection agency dedicated to protecting consumers in the financial products and services markets, except for investment products and services already regulated by the SEC or Commodities Futures Trading Commission. While some have urged the exclusion of all insurance products from this new agency, other proposals have included credit and mortgage insurance under the purview of this new agency. The CFPA could have supervisory, examination and enforcement authority over all entities subject to its regulations.

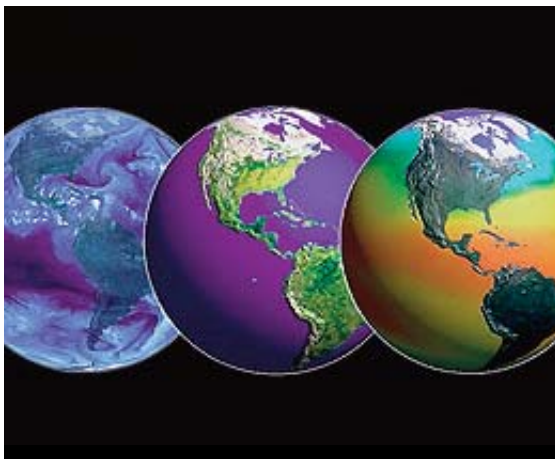
Consolidation of the OTS and OCC into a New Federal Agency and Elimination of Thrift Charters. A newly-created federal agency has been proposed to assume responsibilities of the Office of the Comptroller of the Currency and the Office of Thrift Supervision (OTS). The OTS is the chief regulator of a number of holding companies of federally-chartered thrifts with well known insurance subsidiaries. A new regulator would bring with it a host of regulatory uncertainties, including how aggressively the new regulator would push to regulate the operations of the insurance affiliates of the holding company.

Nonadmitted Insurance and Reinsurance Reform. The House bill on financial regulatory reform includes provisions found in the separately-proposed Nonadmitted and Reinsurance Reform Act. This bill does not provide for federal licensing of surplus lines brokers, but instead would prohibit states outside the insured's home state from applying their licensing requirements to a surplus lines insurance placement. With narrow exceptions, it would also prohibit states – other than the insured's home state – from regulating any other aspect of a surplus lines insurance transaction. Its provisions regarding reinsurance are designed to restrict reinsurance regulation to the domiciliary state of the cedent. If a reinsurance transaction qualifies for credit for reinsurance in the cedent's domiciliary state and that state is accredited by the National Association of Insurance Commissioners (NAIC), then no other state may deny the cedent such credit.

NARAB II. Legislation that would provide for a national system to register insurance agents and brokers by creating a National Association of Agents and Brokers (NARAB II), has been re-introduced in the House. Its goal is to permit licensed insurance producers to operate nationwide after obtaining membership in NARAB II. While the legislation has broad support, it risks being crowded out in a busy legislative agenda.

Optional Federal Charter. What may be most notable regarding the proposals stemming from the financial regulatory reform outlined above is what is not explicitly proposed: a national insurance regulator in the form of an optional federal charter. Legislation proposing an optional federal charter is pending in Congress, but is unlikely to get any significant movement in the coming year as the financial regulatory reform proposals take center stage. However, it is clear from the principles outlined for financial regulatory reform that the current administration and the Treasury are of the view that the time for significant change and action at the state level has arrived. This modernization effort could ultimately lead to optional federal charter legislation some time down the road, especially in the life industry, which believes it is at a considerable disadvantage in competing with banks and other financial institutions primarily regulated by a single federal regulator, and foreign financial services companies with insurance company subsidiaries that prefer a single regulator.

Taxation. A bill introduced in the House would disallow deductions for certain non-life reinsurance premiums paid to affiliated foreign reinsurers. This is the latest action in a long-running controversy over claims by some domestic insurance companies that federal tax laws give offshore reinsurers a competitive advantage with respect to the insurance of U.S. property and casualty risks. In a broader sense, as governments look to shore up deficits and search for new revenue streams, the tax status of insurers and reinsurers will be primary targets. Taxation in the insurance area, including in the health care reforms mentioned above, is ripe for change.



Industry Activity

Mergers & Acquisitions. Difficulty raising capital and the financial crisis has reduced overall activity in the M&A market over the past two years, but as the economy improves we expect a significant increase in mergers and acquisitions and capital raises. A desired increase in size and capital strength for insurers, along with economies of scale in already fragmented markets, will fuel an increase in mergers and acquisition activity. We expect consolidation for both insurers and brokers, and anticipate that some private equity funds that have not been able to sell in depressed conditions will be looking to liquidate their investments.

Life Settlement. We expect life settlement buying and securitizations to increase in 2010, and will keep a close watch on increased regulatory scrutiny of such products, which we expect will continue in 2010. Both the SEC and GAO have task forces studying the life settlement industry, and there have been a number of mini-Madoff-like investment scams in this industry that have become the subject of securities law enforcement actions during the last 18 months.

Industry Developments

Climate Change Heats Up the Insurance Industry. The NAIC has approved a mandatory Insurer Climate Risk Disclosure Survey for the purposes of collecting information from insurance companies concerning their exposures to and plans to address climate change risks that affect their businesses. Mandatory disclosure is due May 1, 2010, for those insurers with annual premium volume over \$500 million. The NAIC White Paper on climate change indicates that this disclosure represents “the beginning of a process rather than the end.” Testifying on behalf of the NAIC in a Senate Hearing, Commissioner Dilweg of the Wisconsin Insurance Department stressed that the NAIC has “taken some important first steps, but more can be done.” These statements foreshadow further action and regulatory scrutiny on climate change.

Cat Bonds & Securitizations. Despite turbulent financial markets, the catastrophe bond market has continued to play a critical role for both sponsors and investors. As financial markets continue to stabilize, we expect catastrophe bond issuance conditions to continue to improve. Issuance was strong in the fourth quarter of 2009, and we expect continued strength in 2010.

Index Linked Annuities. Equity-indexed annuities earn interest that is linked to a stock index. These products are often characterized as falling between a fixed and a variable annuity. A case brought by several annuity companies challenged an SEC regulation treating these products as securities. In response, the SEC recently agreed to delay for two years a rule under which certain indexed annuities would be treated as securities rather than insurance products. The rule had been scheduled to take effect in January 2011, and is the focus of a legal battle between the SEC and certain industry participants. Despite the reprieve by the SEC, the debate over the appropriate classification of these products will continue in 2010.

Reinsurance Collateral. The NAIC approved submission to Congress of the Reinsurance Regulatory Modernization Act of 2009. The proposed legislation would create two new classes of reinsurers in the United States: National Reinsurers and Port of Entry Reinsurers. In order to transact reinsurance business, both national and port of entry reinsurers would be licensed through a single state (either the home state or port of entry state). Reinsurers could also choose to continue under the current regulatory scheme. The legislation would also, among other items, reduce the amount of collateral certain reinsurers would need to post in order for a U.S. cedant to receive credit for reinsurance. At this point, no legislation has been introduced and the prognosis for this NAIC proposal will depend on the outcome of the financial regulatory reform debate discussed above.

Industry Developments (cont'd.)

New York Insurance Exchange. Governor David Paterson recently indicated that the New York Insurance Exchange will be revived in the near future. The exchange would be a Lloyd's type marketplace through which buyers could purchase insurance and reinsurance, and those who want to take on risk could form syndicates. While a previous exchange never gained traction in the 1980s before dissolving, this new exchange could gain momentum in a different economic and regulatory climate in 2010.

Producer Compensation Transparency. The New York Insurance Department published new producer compensation disclosure rules in December of 2009 that could go into effect soon. If effective, the regulation will require all producers to disclose to the purchaser certain items, including whether the producer represents the purchaser or the carrier and information on the compensation the producer receives. The Independent Insurance Agents & Brokers of New York has already threatened legal action if the new rules are implemented.

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State Foreign Assets Control. The California Department of Insurance has requested all insurers licensed in California (foreign and domestic) to provide specific information regarding certain Iranian investments to evaluate whether such investments are sound and in compliance with applicable law. The investigation was launched to ensure insurance industry compliance with a new California state law that prohibits California insurance companies from investing in countries designated as state sponsors of terrorism. The California Commissioner advocated a coordinated nationwide divestment effort with respect to Iran as well as the formation of an NAIC working group or task force to address the issue. Florida Insurance Commissioner Kevin McCarty, secretary-treasurer of the NAIC, also has stated that he is consulting other states' commissioners to see if it is practical to develop a national effort similar to California's. We expect these types of inquiries and divestment efforts to continue throughout 2010.

Accounting Changes

The International Accounting Standards Board (IASB) and the Financial Accounting Standards Board (FASB) have increased the pace of their efforts to develop a common set of accounting standards by the target date of 2011. One area sure to gain attention is insurance contracts, where a long awaited and delayed IASB exposure draft is scheduled to be issued in April 2010. The SEC is considering measures that could lead to adopting International Financial Reporting Standards (IFRS) in the United States (to the possible exclusion of U.S. GAAP standards) as it moves forward with its proposed "Roadmap for the Potential Use of Financial Statements Prepared in Accordance with International Financial Reporting Standards by U.S. Issuers." Regardless of how the SEC moves in its proposed plan, the effects of global reporting standards on U.S. insurers will continue to increase.

Financial Regulatory Reform-Impact on the Insurance Industry (cont'd.)



Life Insurance Reserve Requirements. The NAIC risk-based capital (RBC) system was created to provide a capital adequacy standard that provides a safety net for insurers to assure they hold in reserve enough assets to pay all claims on outstanding policies. The amount of required assets that must be held are currently determined by a formula. During the midst of the financial crisis, the American Council of Life Insurers (ACLI) made a proposal asking the NAIC to lessen the current reserve and risk-based capital standards in the life industry. While the life insurance industry's proposal was rejected by the NAIC, other more limited relief has been provided. In addition, at its Fall 2009 meeting, the NAIC approved critical revisions to the Standard Valuation Law (SVL) that would permit principles-based reserving. The SVL is utilized by states when setting

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What to Expect in 2010

This year promises to be every bit as eventful as the past one, and could be one of the most transformative in regulatory change. Those companies that are able to anticipate and adopt to the changing environment will prosper. We will continue to follow developments in the insurance and reinsurance areas and assist clients in adapting and complying with insurance transactional and regulatory matters.

standards for life reserve calculations. The SVL will embody a new principles-based approach to calculating reserves as opposed to utilizing formulaic calculations, thus creating a monumental shift in life reserving that has existed for over 100 years. Further details and specifics must be finalized in a valuation manual, which should be finalized by the middle of 2010, with ultimate implementation by the following year.

SWAPs Regulated as Insurance. In November 2009, the National Conference of Insurance Legislatures (NCOIL) adopted the Credit Default Insurance Model Legislation based on the assumptions that credit default swaps are insurance and sellers of such products must be licensed by state insurance departments. Federal legislation regarding credit default swaps is also pending, and given the attention and perceived role such products played in the financial crisis, this year could see a significant shift in how these products are regulated.

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