PAUL HASTINGS

An Eye on Insurance

Recent Developments in Insurance Regulation

The last months of 2023 capped off another major year for insurance regulation, with state insurance regulators and the National Association of Insurance Commissioners (the "**NAIC**") undertaking a number of initiatives that will affect the use of artificial intelligence by life insurers, statutory accounting, and other areas. We summarize below the key highlights of these initiatives.

Colorado Begins Regulation of Artificial Intelligence

In September and October, the Colorado Division of Insurance (the "Colorado Division") took the first steps of any U.S. state insurance regulator towards the implementation of a regulatory regime specifically intended to govern the use of artificial intelligence by life insurers. These steps are part of a broader effort by Colorado to develop regulations that address unfair discrimination on the basis of race, color, national or ethnic origin, religion, sex, sexual orientation, disability, gender identity, or gender expression in the use of certain data by insurance companies.

Governance and Risk Management Frameworks

On September 21, 2023, the Colorado Division adopted Regulation 10-1-1 Governance and Risk Management Framework Requirements for Life Insurers' Use of External Consumer Data and Information Sources, Algorithms, and Predictive Models (the "**Regulation**"). The Regulation among other things promulgates governance and risk management requirements regarding the use by life insurers of external consumer data and information sources ("**ECDIS**") or of algorithms or predictive models that use ECDIS (collectively with ECDIS, "**Covered Data**").

The Regulation requires life insurers authorized to do business in Colorado to establish and maintain a risk-based governance structure and risk management framework to (1) oversee whether the life insurers' use of Covered Data potentially result in unfair discrimination with respect to race, and (2) remediate such unfair discrimination if detected. In order for the required framework to be compliant with the Regulation, it must include clearly documented policies, procedures, systems, and controls to detect and address unfair discrimination.

The Regulation also requires senior management of life insurers to be responsible for setting and monitoring the companies' overall strategy for the use of Covered Data. To that end, a crossfunctional governance group composed of representatives from key functional areas must be established to support implementation. In addition, the governance structure and risk management framework must ultimately be overseen by a life insurer's board of directors (or a committee of the board). The Regulation also requires life insurers to monitor any third-party vendors or other external resources for ECDIS and algorithms and predictive models that use ECDIS and ensure that they remain compliant with the frameworks established by such insurers.

Life insurers using Covered Data must file an annual report with the Colorado Division by December 1, 2024 that summarizes their compliance with their governance structure and risk management framework, including listing (i) the title and qualifications of each individual responsible for ensuring such compliance and (ii) the specific requirements of the governance structure and risk management framework for which that individual is responsible. In addition, those life insurers will need to file a report with the Colorado Division by June 1, 2024 describing their progress towards setting up the governance and risk management framework and identifying any difficulties encountered and expected completion date.

Colorado Regulation

Quantitative Testing Use of Artificial Intelligence

On September 27, 2023, the Colorado Division released a draft proposed regulation on Quantitative Testing of External Consumer Data and Information Sources, Algorithms, and Predictive Models Used for Life Insurance Underwriting for Unfairly Discriminatory Outcomes (the "**Draft Regulation**"). Under the Draft Regulation, life insurers authorized in Colorado that use Covered Data would be required to perform annual quantitative testing to evaluate whether the insurers' use of Covered Data are unfairly discriminatory based on the race or ethnicity of proposed insureds. This testing would be specifically focused on evaluating potential unfair discrimination with respect to the following two areas:

- whether Hispanic, Black, and Asian/Pacific Islander applicants are declined for coverage at a statistically different rate relative to White applicants; and

- whether Hispanic, Black, and Asian/Pacific Islander insureds are charged a statistically different premium rate per $1,000 of the face amount of their policies, relative to White insureds.

If this first-level testing indicates a statistical difference of 5% or more with respect to either category, the insurer would be required to conduct second-level variable testing of the Covered Data to identify the specific variable(s) contributing to the difference. Estimation of the race or ethnicity of applicants and/or insureds must be done by utilizing Bayesian Improved First Name Surname Geocoding (BIFSG)—the statistical methodology developed by the RAND Corporation for estimating race and ethnicity—and the applicant's and/or insured's name and geolocation information included in such person's application for life insurance. Under the current language of the Draft Regulation, life insurers would be required to provide the Colorado Division with an annual report regarding testing undertaken pursuant to the regulation by April 1, 2024.

Colorado Draft Regulation

NAIC Fall Meeting

While the Fall meeting of the NAIC saw numerous initiatives undertaken by the various committees of the organization, particularly noteworthy were the adoption of a model bulletin regarding use of artificial intelligence by insurers and ongoing proposed revisions to the statutory accounting regime.

Adoption of Model Bulletin Regarding Use of Artificial Intelligence

On December 4, 2023, the membership of the NAIC voted to adopt the model bulletin pertaining to use of artificial intelligence by insurers (the "**Model Bulletin**"). The adoption of the Model Bulletin does not compel any state insurance regulatory authority to adopt or distribute the Model Bulletin in its final form. It is likely, however, that following the adoption of the Model Bulletin by the NAIC, state insurance regulators will at least consider adopting some version of the bulletin.

The Model Bulletin recognizes that artificial intelligence is transforming the insurance industry and is increasingly being deployed across all stages of the insurance life cycle (including product development, marketing, sales and distribution, underwriting and pricing, policy servicing, claim management, and fraud detection). The NAIC's fundamental concern is that use of artificial intelligence presents unique risks to consumers, including the potential for inaccuracy, unfair discrimination, data vulnerability, and lack of transparency and explainability.

The Model Bulletin requests the creation of an oversight program by insurers with respect to their use of artificial intelligence which is reflective of, and commensurate with, the insurer's assessment of the degree and nature of the risk posed to consumers by the use of artificial intelligence systems, considering: (i) the nature of the decisions being made, informed or supported by artificial intelligence systems; (ii) the type and potential harm to consumers resulting from the use of artificial intelligence systems; (iii) the extent to which humans are involved in the final decision-making process; (iv) the transparency and explainability of outcomes to impacted consumers; and (v) the extent and scope of the insurer's use or reliance on data, predictive models and artificial intelligence systems from third parties.

The Model Bulletin includes general guidelines, such as requirements that any program developed should vest responsibility for the development, implementation, monitoring and oversight of the program in senior management, and for setting the insurer's strategy for artificial intelligence systems with senior management accountable to the board or an appropriate committee of the board. Further, the bulletin notes that the program should address governance, risk management controls and internal audit functions for the use of artificial intelligence systems across the insurance life cycle and across the artificial intelligence system's life cycle. The program should also include processes and procedures for providing notice and appropriate information to impacted consumers and should address all artificial intelligence systems that are in use, whether developed by the insurer or by a third-party vendor.

The Model Bulletin also includes specific guidance regarding: (i) the establishment of a governance framework for the oversight of artificial intelligence systems by an insurer; (ii) the documentation of risk identification, mitigation and management framework and internal controls for artificial intelligence systems; (iii) requirements for an insurer's process for acquiring, using or relying on third-party data and artificial intelligence systems; and (iv) documentation relating to an insurer's artificial intelligence-related systems and its artificial intelligence program that an insurer may be asked to provide in the context of an investigation or market conduct action.

Model Bulletin

Updates from the Statutory Accounting Principles (E) Working Group

On December 1, 2023, the Statutory Accounting Principles (E) Working Group (the “SAPWG”) met and, in a very full session, adopted or exposed a number of concepts and clarifications to existing statutory accounting guidance.

The following adjustments to statutory accounting guidance were adopted at the SAPWG meeting:

a) *Statement of Statutory Accounting Principles (SSAP) No. 2R—Cash, Cash Equivalents, Drafts, and Short-Term Investments*: Adopted new statutory accounting principle (“**SAP**”) concept revisions to further restrict the investments that are permitted for cash equivalent and short-term reporting, with an effective date of January 1, 2025. The revisions exclude all Schedule BA: Other Long-Term Investments and mortgage loans.

b) *SSAP No. 30R—Unaffiliated Common Stock and SSAP No. 32R—Preferred Stock*: Adopted revisions clarify that investments that are in substance residual interests must be reported on Schedule BA on the dedicated reporting line for residuals, effective year-end 2023.

c) *SSAP No. 54R—Individual and Group Accident and Health Contracts*: Adopted revisions clarify that gross premium valuation (under *A-010, Minimum Reserve Standards for Individual and Group Health*) and cash-flow testing (under *Actuarial Guideline LI—The Application of Asset Adequacy Testing to Long-Term Care Insurance Reserves*) are both required if indicated.

d) *Annual Statement Instructions*: Adopted revisions to update and remove guidance that has permitted allocation of non-interest-related losses to the interest maintenance reserve (“**IMR**”) with an effective date of January 1, 2024. The revisions address mortgage loans with valuation allowances and debt securities with known credit events.

The following adjustments to statutory accounting guidance were exposed for comment at the SAPWG meeting:

a) *SSAP No. 21R—Other Admitted Assets*: Exposed revisions to SSAP No. 21R to incorporate a new measurement method for residual interests. The revisions incorporate industry’s proposal of an “effective yield with a cap” method as well as a practical expedient to allow the “cost recovery” method.

    - Exposed for comment until January 22, 2024

b) *SSAP No. 21R—Other Admitted Assets*: Exposed revisions to expand the transparency of reporting for collateral loans on Schedule BA to enable state insurance regulators with the ability to quickly identify the type of collateral that supports admittance of collateral loans.

- Exposed for comment until January 22, 2024

c) *SSAP No. 34—Investment Income Due and Accrued, SSAP No. 48R—Joint Ventures, Partnerships and Limited Liability Companies, SSAP No. 93—Low-Income Housing Tax Credit Property Investments, and SSAP No. 94R—Transferable and Non-Transferable State Tax Credits*: Exposed revisions update the proposed guidance for investments in tax credits as well as acquired tax credits in response to the comments received. Exposure also requests comments on updated annual statement reporting categories for tax credit investment risk-based capital ("**RBC**").

- Exposed for comment until February 9, 2024

d) *SSAP No. 48—Joint Ventures, Partnerships, and Limited Liability Companies*: Exposed revisions to further define for consistency purposes the investments captured as non-registered private funds, joint ventures, partnerships or limited liability companies, or residual interests be reported based on the underlying characteristics of assets.

- Exposed for comment until January 22, 2024

e) *SSAP No. 58—Mortgage Guaranty Insurance*: Exposed intent to review the revisions to the *Mortgage Guaranty Insurance Model Act* (#630) for incorporation into SSAP No. 58 and Appendix A-630 as applicable. The exposure requests input on an effective date.

- Exposed for comment until February 9, 2024

f) *SSAP No. 97—Investments in Subsidiary, Controlled and Affiliated Entities*: Exposed revisions to update the language in paragraph 24 on audits and admissibility to better align with guidance in paragraphs 26 and 27 on the look-through methodology.

- Exposed for comment until February 9, 2024

g) *Various SSAPs, Accounting Standards Update (ASU) 2016-13 Financial Instruments–Credit Losses (Topic 326), Measurement of Credit Losses on Financial Instruments and Other Related ASUs (CECL):* Exposed revisions to reject current expected credit loss (CECL) within *Interpretation (INT) 06-07: Definition of Phrase "Other Than Temporary"* and fifteen applicable SSAPs.

- Exposed for comment until February 9, 2024

h) *Annual Statement Instructions*: Exposed revisions to clarify that realized gains and losses on perpetual preferred stock shall not be added to the IMR, regardless of NAIC designation, and shall follow the same concepts that exist for common stock in reporting realized gains/losses to the asset valuation reserve ("**AVR**").

- Exposed for comment until February 9, 2024

i) *INT 23-04T*: Life Reinsurance Liquidation Questions: Exposed revisions to INT 23-04 provide accounting and reporting guidance for ceding entities with the life reinsurance counterparty, Scottish Re, in liquidation. This requires following existing life reinsurance guidance and requires nonadmission of unpaid claims and other amounts that are either in dispute or not collateralized by an A-785 compliant trust. It allows admission of undisputed claims incurred before contract cancellation, and paid before the reporting period, and undisputed amounts which are secured by an A-785 compliant trust.

- Exposed for comment until December 29, 2024

j) *Appendix D—Nonapplicable GAAP Pronouncements*: The following U.S. generally accepted accounting ("**GAAP**") standards were exposed with revisions to reject, as they are not applicable to statutory accounting: (1) *ASU 2023-03, Amendments to SEC Paragraphs*; and (2) *ASU 2023-04, Amendments to SEC Paragraphs—Cryptocurrency*.

- Exposed for comment until February 9, 2024

SAPWG Materials | *SAPWG Materials*

Cigna Calls Off Potential Acquisition of Humana

On December 10, 2023, the WSJ reported that Cigna Group called off a potential acquisition of Humana, which reportedly would have taken the form of a cash-and-stock transaction with a large stock component. The decision to call off this potential transaction comes approximately six years after previous potential combinations of Humana with Aetna and Cigna with Anthem were both not concluded in the face of competitive impact issues raised by U.S. federal courts, the Department of Justice, and certain state insurance regulators.

WSJ article

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***An Eye on Insurance** is Paul Hastings LLP's quarterly discussion on developments in the insurance industry. For an in-depth discussion of any of the subjects raised in this bulletin, please reach out to sanjivtata@paulhastings.com.*

Paul Hastings LLP's Insurance practice has a comprehensive understanding of virtually all aspects of insurance regulation and has decades of collective experience in insurance and reinsurance industry transactions. For any questions about developments in the insurance industry, please reach out to the leaders of Insurance practice.

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